



# Contract and Fiduciary Duty in Corporate Law

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## CONTRACT AND FIDUCIARY DUTY IN CORPORATE LAW

VICTOR BRUDNEY\*

### INTRODUCTION

The concept "fiduciary" in Anglo-American law has evolved to embrace a wide range of relationships. From its origins in the law of trusts it has been extended to the relationships between a variety of professionals and their clients and further to the world of commerce. In that world it has been invoked in agency, partnership, and corporate relationships, and dubiously has often been said to be entailed in a large number of other contractual relationships, such as banks with borrowers or depositors, franchisors with franchisees, licensors with licensees, and distributorships. The conditions that implicate the fiduciary relationship are comparable, but not identical, across the range of its coverage.<sup>1</sup> The restraints on the fiduciary's self-benefiting behav-

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\* Weld Professor of Law Emeritus, Harvard Law School; Visiting Professor of Law, Boston College Law School. I am indebted for insightful counsel to Lucian A. Bebchuk, David Charny and Scott T. Fitzgibbon who, however, are not responsible for the views expressed in this Article.

<sup>1</sup> Apart from express trust, the fiduciary relationship and corresponding obligations arise when a person either (1) employs the services of another to act on the former's behalf (generally for specified compensation but no other reward) in matters in which the latter may be deemed to have special knowledge or competence that the former lacks, and the latter is intended to have substantial discretionary power over the subject matter of their dealings; or (2) places (or finds placed) in the custody or control of another (who may be deemed to have special knowledge or competence or integrity) property or interests to be preserved or enhanced in the custodian's substantial and effectively unmonitored discretion. Notwithstanding that the parties' relationship may originate in contract or consent, the accompanying fiduciary obligations are imposed by the state, even in the absence of consent to the relationship, or at least the absence of consent to assume those obligations.

ior that attend the finding of the fiduciary relationship are not the same in each category or indeed in all contexts within any category. The same is true for the sanctions imposed for violating such fiduciary obligations.

The variations are said to call for an explanation that relates and justifies them by a coherent theory. Some offer such a theory by rejecting or muting the fiduciary notion, and instead invoking a more or less rigid model to which they attach the label "contract."<sup>2</sup> Others see a less orderly world and offer more complex explanations that reflect many more dimensions of reality and significantly different values than does the simplistic model that the former massage.<sup>3</sup>

Neither "contract" nor "fiduciary" exists in nature. Each is a construct developed in legal discourse to serve normative as well as analytic functions. The contractarians appear to suggest that "contract" and the consequences that contract doctrine prescribes better "fit" or explain all the transactions and arrangements that have been characterized as "fiduciary" than does the construct "fiduciary" alone. Treating those transactions and arrangements as embodiments of "contract" is considered analytically and normatively preferable to treating them as a separate genus labeled "fiduciary." However, because the content of each construct often varies with the context, the suggestions cannot be

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Courts sometimes declare that a fiduciary relationship arises in the absence of a charge to act solely on behalf of another, e.g. franchisor-franchisee, licensor-licensee, bank-lender-depositor. The claim is questionable, even though it is driven by the accurate perception that one party is given substantial discretion in the conduct of the arrangements and power and temptation to appropriate for himself or herself interests or property of the other.

<sup>2</sup> See Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J.L. & ECON. 425 (1993); see also Henry N. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to Anti-Contractarians*, 65 WASH. L. REV. 1 (1990); Charles J. Goetz & Robert E. Scott, *Principles of Relational Contracts*, 67 VA. L. REV. 1089 (1981); John H. Langbein, *The Contractarian Basis of the Law of Trusts*, 105 YALE L.J. 625 (1995).

<sup>3</sup> See generally Alison Grey Anderson, *Conflicts of Interest: Efficiency, Fairness and Corporate Structure*, 25 UCLA L. REV. 738 (1978); Ernest J. Weinrib, *The Fiduciary Obligation*, 25 U. TORONTO L.J. 1 (1975). Some are concerned with the concept of "trust" as it informs a wide range of relationships and transactions. See, e.g., J.C. SHEPHERD, *THE LAW OF FIDUCIARIES* (1981); Tamar Frankel, *Fiduciary Duties as Default Rules*, 74 OR. L. REV. 1209, 1226-30 (1995) [hereinafter Frankel, *Fiduciary Duties*]; Tamar Frankel, *Fiduciary Law*, 71 CAL. L. REV. 795 (1983) [hereinafter Frankel, *Fiduciary Law*]; Eileen A. Scallen, *Promises Broken vs. Promises Betrayed: Metaphor, Analogy and the New Fiduciary Principle*, 1993 ILL. L. REV. 897, 907-11 (1996). Others focus on the fiduciary relationship in the corporate context. See Kenneth B. Davis, *Judicial Review of Fiduciary Decision-Making: Some Theoretical Perspectives*, 80 NW. U. L. REV. 1 (1985); Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 DUKE L.J. 879 [hereinafter DeMott, *Fiduciary Obligation*]; Deborah A. DeMott, *Fiduciary Obligations Under Intellectual Siege: Contemporary Challenges to the Duty to Be Loyal*, 30 OSGOODE HALL L.J. 471 (1992) [hereinafter DeMott, *Contemporary Challenges*]; Lawrence E. Mitchell, *Fairness and Trust in Corporate Law*, 43 DUKE L.J. 425 (1993); see also Rutherford B. Campbell, Jr., *Corporate Fiduciary Principles for the Post-Contractarian Era*, 23 FLA. ST. U. L. REV. 561, 563-64 (1996).

examined or evaluated without first identifying the particular context. As with the fiduciary relationship, to say that a relationship is contractual "only begins analysis; it gives direction to further analysis . . . What obligations does [the contracting party] . . . owe? In what respect has he failed to discharge those obligations? And what are the consequences of his deviation from duty?"<sup>4</sup>

For such analysis it is of little moment whether the concept "fiduciary" is a separate genus or is a species of the concept "contract," so long as its distinctive history, content and normative aspirations are understood and respected. If it is characterized as a species of contract, appreciation of the extent to which its premises, prescriptions and consequences differ from those of other species of contract is crucial. Thus, the structure and aspirations of contract that most often inform the suggestions of contractarians—volitional and unbridled consent by autonomous knowledgeable parties to arrangements whose aspiration is wealth-maximization—do not appear the only vision of contract that courts and commentators articulate. That particular vision embodies perceptions and values about which there is disagreement as a matter of contract doctrine. More importantly, as we shall see, their values differ significantly from the values that the fiduciary notion embodies historically and functionally. To cut through substance to form (i.e. to characterize the fiduciary relationship and its traditional strictures as a form of contract) and then to invoke the form as a fulcrum on which to ratchet down the substantive restrictions uses the term "contract" as an undistributed middle in a problematic syllogism.

The "law" of contract may be analyzed in terms of the parties invoking the state's coercive power to enforce or "complete" their private arrangements or of the state exercising its coercive power to limit the extent to which the parties may engage in, or act under, their private arrangements. In either case, the notion of contract as a private arrangement rests upon the exercise of the state's power and the rules it promulgates to enforce or limit the arrangement.<sup>5</sup> To characterize the state-imposed limits as "default" rules or "background" rules suggests that the parties are free to ignore, or decline to be bound by, restrictions that society imposes to protect individuals, whether paternalistically, or to avoid externalities, or otherwise. The suggestion is that parties are as free to "contract" with one another as they would be in a pre-state world with no such socially-imposed restrictions. That basic structural assumption is problematic. Some of those background

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<sup>4</sup> Cf. *SEC v. Chenery Corp.*, 318 U.S. 80, 85–86 (1942).

<sup>5</sup> See, e.g., Morris R. Cohen, *The Basis of Contract*, 46 HARV. L. REV. 561 (1933); Duncan Kennedy, *Distributive and Paternalist Motives in Contract and Tort Law*, 41 MD. L. REV. 563 (1982).

rules are not permitted to be circumvented by the parties; others are. Even in the latter case, the existence of state-imposed background rules limits the parties' power to "contract around" them (in whole or in part) or to treat their arrangements as if the rules did not exist.

Restrictions on actions by fiduciaries (or by tort-feasors) are state-imposed, as are the limits on the power of the affected parties to alter those restrictions. But both the content of those restrictions and the power to alter them differ from the content and modifiability of the restrictions that "mere" contract law imposes on non-fiduciary, non-tortious, contracting parties. Contractarians' discussion of the notion of contract generally rests on the assumption that the state, apart from enforcing the terms of the contract, imposes only thinly textured restrictions on the parties' behavior vis-a-vis one another before (and in the course of performing) their contract. But fiduciaries start with thick restrictions that substantially hamper their freedom to act with respect to, or to alter their state-imposed obligations to, their beneficiaries. The conditions that generate state-imposed fiduciary restrictions<sup>6</sup> not only impel limits on the fiduciary's power, but they impel limits on the beneficiary's power (both procedurally and substantively) to consent to departure from those restrictions. Those limits are more rigorous than the limits on the non-beneficiary's power to consent to departure from the restrictions of "mere" contract doctrine.<sup>7</sup> To that extent, at least, fiduciary restrictions are more compelling than "mere" contract restrictions.

Discussion of corporate law by legal academics recurringly focuses on the question whether restrictions on the behavior of management (directors and executive officers) and controlling stockholders of investor-owned publicly held corporations in benefiting themselves from dealing with the corporation, its assets or the holders of its common stock are, or should be, derived from the notion of fiduciary relationship or of contractual relationship *simpliciter*. Those discussions implicate the questions whether there is or should be any difference between the two notions in that context, and if so, whether the conditions that generate the fiduciary relationship require restrictions on, and consequences for, the parties in matters of loyalty that contract theory, at least classic contract doctrine, would not require or permit.<sup>8</sup>

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<sup>6</sup> See *supra* note 1 and *infra* notes 15, 41 & 82.

<sup>7</sup> See *infra* notes 78-81 and accompanying text.

<sup>8</sup> The "fiduciary" construct may appropriately be contrasted with the "contract" construct (meaning by the latter the more or less conventional visions of contract and the rules that govern them) rather than be treated as a species of contract. The existence of the one does not preclude the simultaneous existence of the other in any particular arrangement or transaction.

To focus on loyalty or distributive matters is not to ignore managerial behavior that may appropriately be challenged for violation of the other essential obligation of fiduciaries—the duty of care in serving the beneficiary's interest.<sup>9</sup> Conduct that may violate that obligation is frequently also challengeable for violation of the duty of loyalty.<sup>10</sup> But in the case of investor-owned publicly held corporations, the principal normative concern for the law and lawyers over the years has been with the loyalty aspect of management's (including directors') and controlling stockholders' fiduciary obligations.<sup>11</sup> That emphasis on loyalty reflects substantial doubt that the "care" obligation entails a useful norm of behavior.<sup>12</sup>

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<sup>9</sup> Legal conventions divide fiduciary obligations into obligations of loyalty and obligations of care. The latter require some level of attentiveness, some process for (and actual) acquisition or possession of relevant information, some reasoned deliberation in performing services, and exercise of some conscious (but virtually unrestricted) judgment about acceptable levels of return per unit of risk or other measure of enhancing stockholder well-being.

The obligation of loyalty is to serve the interests of the beneficiary rather than those of the fiduciary. In its most demanding form, it requires the fiduciary to serve *solely* the beneficiary's interests and to refrain from any kind of behavior (in performing services or in dealing with the beneficiary or the property in its control) from which the fiduciary may gain in excess of specified compensation—even if such behavior imposes no cost on the beneficiaries or, indeed, if the failure to engage in such behavior causes a loss to them.

<sup>10</sup> See, e.g., David Morris Phillips, *Managerial Misuse of Property: The Synthesizing Thread In Corporate Doctrine*, 32 *RUTGERS L. REV.* 184 (1979); Nat Stern, *The Practicality of Outreach Statutes Enforcing Directors' Duty of Care*, 72 *NEB. L. REV.* 905, 936–42 (1993). Thus management's pursuit of growth, at the possible cost of increased return per unit of risk, or search for the quiet life, or less risky investments than those that diversified stockholders should rationally prefer, may entail potential violation of the latter duty as well as the former.

<sup>11</sup> Notwithstanding occasional overlapping coverage of the same behavior by the two duties, the duty of loyalty does not subsume *all* the benefits to fiduciaries from violation of the duty of care, in fair part because some of those benefits are too ephemeral to be identified and it is too costly to make them sanctionable. But that does not mean that diversion of the more visible or tangible assets of the firm should not be assessed more critically for what it is—appropriation by the fiduciary of the beneficiary's property—and be treated more severely than most violations of the duty of care.

Economists tend to view the behavior addressed by the two duties as a continuum under the rubric "agency costs" and to analyze them simply as a matter of contract or "incomplete contract." That view marginalizes the difference between matters of care and matters of loyalty in human behavior. But apart from the margin, analytically different considerations are involved in delineating and normatively different consequences attend violation of the duties of care and loyalty. By the same token, economists' view of contract generally leaves little or no room for fiduciary notions—a view that also scants relevant differences in human behavior. Differences between the visions of economists and lawyers in these matters have been noted in Lewis A. Kornhauser, *Unconscionability in Standard Forms*, 64 *CAL. L. REV.* 1151, 1153–57 (1976) and Avery Katz, *Your Terms or Mine? The Duty to Read the Fine Print In Contracts*, 21 *RAND J. OF ECON.* 518, 520–22 (1990). Compare Oliver E. Williamson, *Calculativeness, Trust, and Economic Organization*, 36 *J.L. & ECON.* 453 (1993), with Bruce Chapman, *Trust, Economic Rationality, and the Corporate Fiduciary Obligation*, 43 *U. TORONTO L.J.* 547 (1993).

<sup>12</sup> The level of care required by the fiduciary standard is low, and the quality of judgment required is even lower. The goad to induce managerial behavior to maximize stockholder wealth

Exploration of questions of loyalty implicates another question that is also currently discussed in corporate law: whether management or controlling stockholders have, or should have, fiduciary obligations of loyalty, rather than only contractual obligations, to investors in straight senior securities (like straight preferred stock or bonds or debentures), hybrid securities (such as convertibles, options, non-voting or differentially voting common stock) or the burgeoning phenomena known as derivatives.<sup>13</sup> This article compares the doctrinal and functional bases of the loyalty obligations of management and controllers of public corporations to public holders of common stock, with the functional and appropriate doctrinal obligations of common stock (and the management it selects) to senior securities.

Part I examines the classic fiduciary doctrine of loyalty (the conditions that underpin the traditional fiduciary relationship and the categorical obligations to refrain from self-aggrandizing behavior that the state imposes upon the fiduciary) and its predicate—the exclusive benefit principle. It then discusses the abandonment of that predicate and the doctrinal dilution of those obligations in the cases of corporate management and controlling (common) stockholders. Notwithstanding the magnitude of the dilution, however, corporate law continues to characterize the relationship and its obligations as fiduciary.

Part II compares the conditions, normative assumptions, and content of traditional fiduciary loyalty analysis with those of traditional contract doctrine. It also compares the restraints imposed by contract

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is virtually non-existent; the incentive of reward, rather than the sanction of punishment, is the preferred stimulus to agents' efforts. Moreover, courts have limited competence in such matters and great reluctance to examine claims of violation of the obligation of care. And more recently, legislatures have provided or authorized exculpation from monetary damage for violation of the duty of care. See, e.g., DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 1996); N.Y. BUS. CORP. LAW § 402(b)(1) (McKinney Supp. 1997); REVISED MODEL BUS. CORP. ACT § 2.02(b)(4) (1994). Except for directors of financial institutions, claims for such violations have rarely been invoked successfully in the courts. See, e.g., DENNIS J. BLOCK ET AL., *THE BUSINESS JUDGMENT RULE* 63–96 (4th ed. 1993 & Supp. 1995); Joseph W. Bishop, *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078 (1968). Behavior that the duty of care is designed to control, therefore, does not entail the conduct that is the principal concern of economists or organization theorists—optimizing performance and maximizing wealth. The duty of care addresses only the minimum level of required performance by an agent. To be sure, if violation of that duty occurs, it may be of significantly larger economic interest to society and investors than much of the conduct at which the duty of loyalty is aimed. But matters of loyalty are generally of substantial consequence, particularly as they are said to have spill-over effects on optimal managerial behavior.

<sup>13</sup> This article is not concerned with the larger problems of corporate governance that are raised by the "new wave" of scholarship that sees the corporation as a socio-economic unit with a variety of contributors, participants and claimants—such as employees, suppliers, consumers, the community, etc.—and addresses the problems of management's obligations to each of those stakeholders. See generally PROGRESSIVE CORPORATE LAW (Lawrence E. Mitchell ed. 1995); Symposium, *Corporate Malaise—Stakeholder Statutes: Cause or Cure?*, 21 STETSON L. REV. 1 (1991);



doctrine on managerial or controllers' self-aggrandizing behavior with the restrictions imposed both by traditional fiduciary obligations and by diluted corporate fiduciary obligations. Part II includes in its examination of contract doctrine not only those restraints against opportunistic behavior imposed by lean classic doctrine, but also those restraints that would be imposed by richer notions developed in contract doctrine—e.g., the concepts of duress, adhesion and the evolving concepts of unconscionability and good faith. Finally, Part II examines the particular concept of contract urged by contractarians as the *summum bonum* and the differences between its normative aspirations and those of fiduciary loyalty doctrine—even as that doctrine is thinned in the corporate context.

Part III argues that the restrictions on self-aggrandizing behavior that are grounded in fiduciary loyalty doctrine, whether classic or corporate, are inappropriate both analytically and normatively in restraining the behavior of common stock holders (and the management that they elect) vis-a-vis holders of senior securities. But dispersed senior investors are in need of limits on opportunistic behavior by common stock holders to whom they necessarily give ambiguous consent and considerable discretion in decision-making for the enterprise. Part III suggests a contract-based approach that might appropriately protect the public senior security holder against opportunistic behavior by common stock holders without unduly limiting the latter's discretion to optimize performance and maximize values.

## I. FIDUCIARY OBLIGATIONS OF CORPORATE MANAGEMENT AND CONTROLLERS TO HOLDERS OF COMMON STOCK

### A. Background

#### 1. Trusts and Agency

From its origins in the law of trusts and its invocation in agency relationships, the fiduciary obligation of loyalty has entailed the exclusive benefit principle and a kind of prophylactic prohibition on self-dealing. The notion is that the fiduciary's duty of loyalty requires the trustee or agent to act as the beneficiary's (or principal's) alter ego and act only as the latter would act for himself. At least as between the fiduciary's interest and the beneficiary's interest the fiduciary is to serve *only* the latter.<sup>14</sup> To assure such exclusive service, the fiduciary is

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Symposium, *The Corporate Stakeholder Conference*, 43 U. TORONTO L.J. 297 (1993); Symposium, *New Directions in Corporate Law*, 50 WASH. & LEE L. REV. 1373 (1993).

<sup>14</sup> See *supra* note 1.

to refrain from engaging in any transaction with the trust's or principal's assets, or the beneficiary or principal, from which he *might* either gain for himself or harm the beneficiary.<sup>15</sup> To be sure, the trustee does not function as an altruist who foregoes all concern with advancing self-interest. With rare exceptions the fiduciary expects, and receives, compensation for performing his or her function. That compensation is provided by the express terms of the arrangement, or by the courts in the absence of such a provision. But apart from such compensation, the exclusive benefit principle precludes rewards to the fiduciary.

While the prophylactic component of the principle may not be implemented uniformly, the theme of exclusive benefit informs the trustee's and agent's obligations. The strictures thus evolved by courts of equity are normally enforced by sanctions that, consonant with the exclusive benefit principle and the reasons for prescribing such rigorous restraints, are designed to deter those fiduciaries from even approaching the borders of self-aggrandizing behavior.<sup>16</sup> These strictures

The essence of a fiduciary relationship is that the fiduciary agrees to act as his principal's alter ego rather than to assume the standard arm's length stance of traders in a market. Hence the fiduciary is not armed with the usual wariness that one has in dealing with strangers; he trusts the principal to deal with him as frankly as he would deal with himself—he has bought candor.

United States v. Dial, 757 F.2d 163, 168 (7th Cir. 1985); see also *Original Great Am. Chocolate Chip Cookie Co. v. River Valley Cookies, Ltd.*, 970 F.2d 273, 280 (7th Cir. 1992); *Jordan v. Duff & Phelps, Inc.*, 815 F.2d 429, 438 (7th Cir. 1987); *Love v. Fire Ins. Exch.*, 271 Cal. Rptr. 246, 253 (Ct. App. 1990); cf. *Industrial Representatives, Inc. v. CP Clare Corp.*, 74 F.3d 128, 131–32 (7th Cir. 1996) (discussing permissibility of seeking and retaining personal advantage under contract law).

Trustees may have fiduciary duties to conflicting claimants (e.g., life tenants and remaindermen) but they are not themselves such claimants. Whatever may be the specifications by the settlor or other criteria that should determine how the trustee should resolve such conflicts between persons other than the trustee, the exclusive benefit principle is not involved in—and does not preclude the trustee from effecting—resolution of conflict between parties neither of whom appointed him as its sole agent. It simply precludes the trustee from obtaining any benefit for itself from the resolution of those conflicts.

<sup>15</sup> See *Keech v. Sandford*, 25 Eng. Rep. 223 (1726); see also *Mosser v. Darrow*, 341 U.S. 267, 271 (1951); *Estate of Swiecicki*, 477 N.E.2d 488, 490 (Ill. 1985); *Matter of Gleeson's Will*, 124 N.E.2d 624, 626 (Ill. App. Ct. 1955); 2A AUSTIN WAKEMAN SCOTT & WILLIAM FRANKLIN FRATCHER, *THE LAW OF TRUSTS* § 170 (4th ed. 1987); RESTATEMENT (SECOND) OF TRUSTS § 170 and cmts. b & j (1959). The same considerations that disable the parties from proscribing specified conduct in advance impel prophylactic prohibitions that substitute for the impossible task of parsing the extent of permissible gains to the errant fiduciary in any particular case. See, e.g., *Milbank, Tweed, Hadley & McCloy v. Boon*, 13 F.3d 537, 543 (2d Cir. 1994); *Thorpe v. Cerbo, Inc.*, 676 A.2d 436, 442 (Del. 1996); Robert Cooter & Bradley J. Freedman, *The Fiduciary Relationship: Its Economic Character and Legal Consequences*, 66 N.Y.U. L. REV. 1045 (1991). That the judiciary occasionally recognizes a fiduciary's compensable contribution in the context of a prohibited self-serving transaction, see *Boardman v. Phipps*, 2 App. Cas. 46 (H.L. 1967), does not detract from this conclusion.

<sup>16</sup> See *supra* note 15.

contemplate not merely compensating beneficiaries for losses, but forcing disgorgement of the fiduciary's gains even when the beneficiary is not shown to have been harmed. They include tracing by way of imposing a constructive trust or by awarding to the beneficiary increments to those gains; and they implicate punitive sanctions such as denying the trustee or agent any compensation.<sup>17</sup>

The exclusive benefit principle and its prophylactic implementation impose the costs of over-prohibition on the beneficiary, the fiduciary and society. Transactions that might be beneficial to all may be required to be foregone in order to ensure that the beneficiary receives the full benefits of the fiduciary's services. Presumably, a regime of over-prohibition obtains in the trust and the agency contexts because the power and magnitude of the fiduciary's temptations to benefit himself at the possible expense of the beneficiary are coupled with insurmountable problems in inducing him to resist that temptation. Those problems stem largely from difficulties in specifying and monitoring (and the cost of litigating over compliance with) terms that would permit self-aggrandizing transactions only if they were value-increasing and the beneficiary was benefited or not harmed by them.<sup>18</sup> The damper on the fiduciary's incentives that a prophylactic rule creates may impose additional costs.<sup>19</sup> On the other hand, a regime of under-prohibition may result in higher cost to beneficiaries and

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<sup>17</sup> See E. Allan Farnsworth, *Your Loss or My Gain? The Dilemma of the Disgorgement Principle in Breach of Contract*, 94 YALE L.J. 1339, 1354-60 (1985); see also *Tarnowski v. Resop*, 51 N.W.2d 801, 802-03 (Minn. 1952) (agency); *Rothko v. Reis*, 372 N.E.2d 291, 297-99 (N.Y. 1977) (punitive damages); *Equity Corp. v. Groves*, 60 N.E.2d 19, 21 (N.Y. 1945) (corporate management); *Wendt v. Fischer*, 154 N.E. 303, 304 (N.Y. 1926) (principal-agent); *Docker v. Somes*, 39 Eng. Rep. 1095, 1098 (Ch. 1834) (express trust). While there is argument over how harsh the permissible penalties may be, see SCOTT & FRATCHER, *supra* note 15, at 320-23; Richard V. Wellman, *Punitive Surcharges Against Disloyal Fiduciaries—Is Rothko Right?*, 77 MICH. L. REV. 95 (1978), there is no doubt of the disgorgement and constructive trust requirements and deterrent aims of the sanctions. See, e.g., *Snepp v. United States*, 444 U.S. 507, 510, 515-16 (1980) (agent); *Mosser v. Darrow*, 341 U.S. 267 (1950) (bankruptcy trustee); *Marcus v. Otis*, 168 F.2d 649, 656-57 (2d Cir. 1948) (corporate directors); *Swiecicki*, 477 N.E.2d at 491; RESTATEMENT (SECOND) OF TRUSTS §§ 202-206 and cmts. (1959); GEORGE E. PALMER, *THE LAW OF RESTITUTION* § 2.11 (1978 & Supp. 1996); Weinrib, *supra* note 3, at 19.

<sup>18</sup> See Davis, *supra* note 3, at 53-59; see also *infra* note 50.

<sup>19</sup> Quite apart from whether the cost of value-increasing transactions lost by the prophylactic rule exceeds the cost of unprofitable value-decreasing transactions averted by that rule is the possible cost of the rule on the fiduciary's incentives. See *infra* text accompanying notes 49-54. The fiduciary's willingness to act solely on the beneficiary's behalf is not an act of selflessness or altruism. Generally the fiduciary is compensated for accepting the role, and that compensation is assumed to be sufficient so that no other benefits (such as may be obtained by self-dealing) are needed to induce performance of duties. Hence, at least at the outset of the relationship, the exclusive benefit principle need not deprive the fiduciary (trustee or agent) of the requisite incentive. But see *infra* note 28.

possibly society than would invoking the exclusive benefit principle. Whether—and how significantly—an under-prohibition regime would or would not increase costs are empirical questions.<sup>20</sup>

In any event, evaluating the fiduciary obligation of loyalty on the premises of net cost savings in a regime dedicated to wealth-maximization is not the only approach to assessing the rules that implement fiduciary obligations. Values other than wealth-maximization are also served by the vision of human interaction underlying the fiduciary notion of loyalty, whether they entail the concept of "trust" with its moral underpinning and richer, more complex view of humans and their societal relationships,<sup>21</sup> or the more modest notion of non-pecuniary relief from personal worry over possible self-appropriating behavior by the trustee or agent. Non-pecuniary benefits of that sort may be viewed as implications of richer normative values than monetary wealth-maximization. Or they may be deemed to constitute a second-order offset (in a broad calculation of "interest" or "utilities") to any short-fall from monetary wealth-maximization in a rational wealth-maximizing world. In short, the fiduciary relationship and its obligations serve functions not addressed by "mere" contract in a world that puts a premium on individual autonomy, let alone in a cooperating world that takes a broader view of the psychological and social needs and functions of human beings.

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<sup>20</sup> Even without serious empirical inquiry, the tension between the costs and benefits of over-inclusion and under-inclusion may be addressed by relaxing the categorical prohibition and *pro tanto* diminishing the beneficiary's protection and substituting a more or less comprehensive regime of regulation of the trustee's behavior. See generally Daniel Fischel & John H. Langbein, *ERISA's Fundamental Contradiction: The Exclusive Benefit Rule*, 55 U. CHI. L. REV. 1105 (1988); Langbein, *supra* note 2; Laurence B. Wohl, *Fiduciary Duties Under ERISA: A Tale of Multiple Loyalties*, 20 U. DAYTON L. REV. 43 (1994). The role of the indentured trustee might have been fiduciary at one time, but it no longer is. See, e.g., 15 U.S.C. § 77000 (1994); S. REP. NO. 101-55, at 29-35 (1989); John P. Campbell & Robert Zack, *Put A Bullet in The Poor Beast. His Leg is Broken and His Use Is Past*, 32 BUS. L. 1705 (1977). See also *infra* note 27.

Whether that relaxation and concomitant regulation adequately protect beneficiaries, and the extent to which those changes are driven by the demands of efficiency rather than by the raw political power of the trustee, are questions for further analysis and debate. For example, as trustees' functions evolve historically to manage liquid assets rather than real property, to what extent does the relaxation of the exclusive benefit principle reflect different requirements of efficiency in managing the one rather than the other, or different allocations of political power between settlors and beneficiaries on the one side and fiduciaries on the other?

<sup>21</sup> See, e.g., TRUST: MAKING AND BREAKING COOPERATIVE RELATIONS (D. Gambetta ed. 1988) (particularly, P. Dasgupta, *Trust As a Commodity*, at 49, and D. Gambetta, *Can We Trust Trust*, at 213). See also Robert C. Clark, *Agency Costs Versus Fiduciary Duties*, in PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS 55, 75-76 (John W. Pratt & Richard J. Zeckhauser eds., 1985); Frankel, *Fiduciary Duties*, *supra* note 3, at 1226-30; I.M. Jackman, *Restitution for Wrongs*, 48 CAMBRIDGE L.J. 302 (1989); G. Richmond Shell, *Opportunism and Trust in the Negotiation of Commercial Contracts: Toward a New Cause of Action*, 44 VAND. L. REV. 221, 258-64 (1991). But see Hardin, *Trusting Persons, Trusting Institutions*, in STRATEGY AND CHOICE 185 (Zeckhauser ed. 1993); Williamson, *supra* note 11.

The costs of the exclusive benefit principle are lessened by relaxing the prophylactic requirement and accepting rules providing that some specified self-aggrandizing transactions by the fiduciary are permitted if the beneficiary or principal freely gives informed, express consent to them, or a court or legislature authorizes them.<sup>22</sup> It is the power thus to authorize (or consent to) departure from the exclusive benefit principle (coupled with the initial consent to enter into the relationship) that is said to establish that the fiduciary relationship is simply a species of contract. It is not necessary to insist that the fiduciary relationship is a separate genus, rather than a species of contract, in order to recognize that it is different from any other species of contract, and that it embodies significantly different prescriptions for the parties' behavior. Valid consent by a beneficiary requires meeting considerably more rigorous conditions than does comparable consent by parties to contracts (or other species of contract)—reflecting the considerable differences between the autonomy of the parties in, and the functions of, the relationships.

Thus the considerations that generate the exclusive benefit principle (if not its prophylactic implementation) require limiting the kinds of transactions in which a beneficiary can validly waive it. They require the fiduciary to take steps to alter effectively the atmosphere of obligation or reliance, so that the beneficiary and the fiduciary can deal freed from the shadow of the trustee's status and the beneficiary's dependence.<sup>23</sup> Hence the trustee is obliged to disclose fully all the information relevant to the transactions, including the gain to the trustee, and possible disadvantages to the beneficiary. Moreover, because the prior status or dependence and the beneficiary's resulting non-wariness cannot be completely eliminated, fiduciary doctrine imposes an overriding restriction of fairness in order for the consent to be valid. To describe the state-imposed limitations on a trustee's self-serving behavior as default rules that can be waived is not to make them the same (in content or in waivability) as default rules that can be waived for "mere" contract engagement.<sup>24</sup>

The exclusive benefit principle may be more costly for the relationship between agents and commercial principals, in which the aspi-

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<sup>22</sup> See, e.g., RESTATEMENT (SECOND) OF TRUSTS §§ 170 cmt. w, 216, 222 (1959). That a settlor may empower a trustee to self deal, see, e.g., *Dutton v. Willner*, 52 N.Y. 312 (1873), does not relieve the trustee of either procedural requirements or substantive limitations otherwise imposed by fiduciary obligations. See RESTATEMENT (SECOND) OF TRUSTS § 170 cmt. t; SCOTT & FRATCHER, *supra* note 15, at § 170.9; see also Davis, *supra* note 3, at 44–46 & n.128.

<sup>23</sup> See RESTATEMENT (SECOND) OF TRUSTS §§ 170, cmt. w, 222, 216; SCOTT & FRATCHER, *supra* note 15, at § 170.9; RESTATEMENT (SECOND) OF AGENCY §§ 387, 390 & cmt. a (1959); see also *infra* notes 79–81.

<sup>24</sup> Langbein appears to make such a claim. See Langbein, *supra* note 2, at 650–67. The

ration may be more to maximize than to preserve values.<sup>25</sup> Moreover, the exclusive benefit principle may be less necessary. Commercial principals have more power, and generally more ability, than trust beneficiaries to specify strictures and to consent to alterations in them, as well as to supervise and terminate the agents' activities. But the benefits of specialization dictate relieving the principal of the difficulties of the first and the cost of the last two. The prophylactic prohibition avoids those difficulties and costs, along with the cost of litigating compliance with inevitably inadequate specifications. The wealth-increasing objective of the relationship may be tempered by the duty to serve solely the interests of the principal because the resulting restrictions on the agent's behavior cast a shadow over maximizing activities in transactions that implicate self-dealing. The extent, if any, to which that shadow hinders monetary wealth-maximization is open to debate.<sup>26</sup> But even if it does, as with trusts do in the principal-agent relationship, the fiduciary notion focuses on encouraging trust and on cognate distributive aspirations, if necessary, at the expense of purely wealth-maximizing aspirations.

The conflicting pulls of these considerations doubtless account for the co-existence of the exclusive benefit principle and deterrent sanctions in the commercial agency relationship<sup>27</sup> and the principal's power to consent to departure from them. That power is more plausible in the case of a commercial principal than in the case of a trust beneficiary.<sup>28</sup> But like a trust beneficiary's power to consent, it is lim-

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differences between the fiduciary and contract concepts and rules and their waivability in the corporate context are discussed *infra* notes 79–102 and accompanying text. The Restatement (Second) of Trusts and Scott and Fratcher characterize a trust relationship as different from a contract relationship and point to attributes that seem to differentiate the two. See RESTATEMENT (SECOND) OF TRUSTS §§ 170 cmt. w, 216, 222; see also Frankel, *Fiduciary Duties*, *supra* note 3, at 1215–30.

<sup>25</sup> In that context, the costs of the exclusive benefit principle and the interdiction of self-serving transactions may result in over-inclusive strictures that exceed the costs of under-inclusive strictures by a greater margin than in the context of trusts. The commercial agent must be vested with discretion to take risks that would be inappropriate if the goal were merely to preserve assets. Prophylactically forbidding transactions implicates the loss of higher level risk, and therefore presumably higher level profit, transactions. But the exclusive benefit principle is nevertheless the governing norm. See RESTATEMENT (SECOND) OF AGENCY §§ 387, 389 & cmt. c, 390 (1959).

<sup>26</sup> See *infra* notes 50–54 and accompanying text.

<sup>27</sup> See *Tarnowski v. Resop*, 51 N.W.2d 801, 802–05 (Minn. 1952); *Wendt v. Fischer*, 154 N.E. 303, 304–05 (N.Y. 1926); RESTATEMENT (SECOND) OF AGENCY §§ 387–396, 407 (1959); cf. Scallen, *supra* note 3.

As comprehensive regulatory supervision is imposed to govern the relationship of principal and agent—as in the case of stockbrokers or investment advisors—the demands of the exclusive benefit rule may be relaxed. See, e.g., Securities and Exchange Act of 1934 § 28(E), 15 U.S.C. § 78bb (1994); 17 C.F.R. 240.15c1–8, 240.15c2–6 (1997) (e.g., front-running, mark-up policy, etc.).

<sup>28</sup> The commercial agent may decline to serve unless rewarded with a return from the product produced by the services. To permit an agent's reward to depend, in whole or in part,

ited in scope and subject to restrictive conditions, albeit possibly less so.<sup>29</sup> Hence, neither the existence of the power to consent nor its exercise makes circumvention of the exclusive benefit principle the norm or transmutes fiduciary relationships (and obligations) into simple contractual ones.<sup>30</sup> Even if fiduciary strictures can be waived, their existence and the limitations on their waivability offer protection to principals and beneficiaries against the kinds of disadvantageous risk—return allocations or reallocations to which parties to “mere” contract are exposed.

## 2. Partnership

The fiduciary rules that govern restrictions on partners in the partnership relationship respond to different conditions than those

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upon the result of the services rendered effectively entitles the agent to share in the assets or gains as would a partner or controlling stockholder, and it is likely to set up conflicts of interest and incur social costs. See RESTATEMENT (SECOND) OF AGENCY § 138 & cmt. c (1959). The cost to the agent of performing services that may produce benefits for the principal and for society may at some point in the process exceed the benefit to it of any increase in compensation (i.e., in the present value of the uncertain expected value of the product) that depends upon the agent's continued effort. Contingent fees to lawyers—whether in personal injury actions for individuals or in class actions generally—illustrate this possibility. Thus, allowing the agent an interest in the result of his service should be, and is, *pro tanto*, a rejection by the principal of the prophylactic prohibition and consent to relaxation of the exclusive benefit principle. It is conditioned upon (1) either free and informed consent to such “compensation” by a principal or by visible institutional needs of a dispersed constituency for the particular services on the particular terms—e.g., a lawyer's contingent fee—and (2) in the latter case by close judicial supervision of the resulting compensation. See generally Mark P. Gergen, *The Use of Terms in Contract*, 92 COLUM. L. REV. 997 (1992).

<sup>29</sup> In the commercial agency context, such consent is likely to be given by a knowledgeable actor able to make a comprehending decision. But the principal's decision is clouded by the inevitable information disadvantage that must be offset by adequate disclosure, and it is trammelled by the restraints affecting attempted modifications of any arrangements negotiated *in medias*. See generally Varouj A. Aivasian et al., *The Law of Contract Modifications: The Uncertain Quest for a Bench Mark of Enforceability*, 22 OSGOODE HALL L.J. 173 (1984).

There may be fewer problems to empowering a principal, who is likely to be knowledgeable than empowering a trust beneficiary who is not, to consent in advance to specified kinds of transactions. As in trusts, to validate the principal's consent, the agent must make adequate disclosure, the principal must be able to act freely and the transaction must be “fair.” See, e.g., *Merrill Lynch Pierce Fenner & Smith v. Cheng*, 901 F.2d 1124, 1128 (D.C. Cir. 1990); RESTATEMENT (SECOND) OF AGENCY §§ 390, 392 (1959). Moreover, the agent remains subject to deterrent sanctions that are not present in simple contract relationships. See, e.g., RESTATEMENT (SECOND) OF AGENCY §§ 399–407 (1959); see also *Gelfand v. Horizon Corp.*, 675 F.2d 1108, 1111–13 (10th Cir. 1982); *Tarnowski v. Resop*, 51 N.W.2d, 801 803–05 (Minn. 1952); *Andrews v. Ramsay & Co.*, 2 K.B. 635 (1903); Davis, *supra* note 3, at 99 n.130; Graham Douthwaite, *Profits and Their Recovery*, 15 VILL. L. REV. 346 (1970).

<sup>30</sup> The exclusive benefit principle governs, but its impact is tempered when the self-dealing takes the form of the agent's use of the principal's property rather than the form of an exchange transaction or a secret profit, because the issue is cast in terms of whose “property” is the agent using—as in *Sun Dial Corp. v. Rideout*, 108 A.2d 442 (N.J. 1954), or *Reading v. Attorney-General*, 1 All E.R. 617 (H.L. 1951).

generating obligations of trustees or of many, perhaps most, commercial agents. The exclusive benefit principle, with its prophylactic concomitant, addresses many kinds of appropriative behavior by a partner, such as personally selling goods to, or buying them from, the firm or taking a partnership opportunity for himself, without the fully informed consent of the other partners.<sup>31</sup> But partners, unlike trustees or agents generally (who are likely to have specified fixed compensation arrangements but little or no personal interest in the assets involved), look for the bulk of their return from the relationship to the increase in the value of partnership assets in which they share ownership and revenues from operating those assets.<sup>32</sup>

That process of sharing affects the operation of the strictures of the exclusive benefit principle and its prophylactic prohibition in self-aggrandizing transactions. Because those principles prohibit the fiduciary from serving or benefiting himself *separately* in dealing with the beneficiary's assets, they require return to the principal or beneficiary of *all* gain and payment of all damage from self-dealing. But in the case of a partner, the beneficiary or the principal is the partnership. Because the errant partner is entitled to share in partnership assets,<sup>33</sup> the sanction for the self-dealing transaction does not deprive him of his pro-rata or contractual share of the gains or damages returned to the partnership. Nevertheless he is not entitled to pursue his *own* self-in-

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<sup>31</sup> Current partnership doctrine is anchored in the common law as specifically altered by the U.P.A. See, e.g., UNIF. PARTNERSHIP ACT §§ 4, 5 (1914), 6 U.L.A. 250, 254 (1995); see also Page v. Page, 359 P.2d 41 (Cal. 1961). Partners (at least active partners) generally can specify and monitor the fiduciary's (i.e., other partner's) behavior more readily than can the beneficiary of a trust or a commercial principal. But the cost of being required to specify or monitor the behavior of each partner across a broad spectrum of conduct over the expected duration of a business partnership suggests that efficiency as well as equity requires protection for each party against the other that is comparable to that required against agents. The exclusive benefit principle informs that protection, as is evident from cases requiring the partner to return the proceeds from all self-dealing to the partnership. See, e.g., U.P.A. § 21; see also Jerman v. O'Leary, 701 P.2d 1205, 1210 (Ariz. Ct. App. 1985); Marsh v. Gentry, 642 S.W.2d 574, 575 (Ky. 1982); Birnbaum v. Birnbaum, 539 N.E.2d 574, 576 (N.Y. 1989); Meinhard v. Salmon, 164 N.E.2d 545, 547 (N.Y. 1928); ALAN R. BROMBERG & LARRY E. RIBSTEIN, BROMBERG AND RIBSTEIN ON PARTNERSHIP § 6.07 (1996). The indeterminacy of the scope of possible misbehavior that underpins the prophylactic prohibition is addressed insofar as the remedy requires return of *all* benefits received in all such transactions to the partnership.

<sup>32</sup> Those returns to partners are likely to be provided quite apart from any compensation fixed in their agreement. As Story pointed out long ago, ordinary agents differ from partner agents because the latter have "a community of interest with the other partners in the whole property and business and responsibilities of the partnership; whereas an agent, as such, has no interest in either." JOSEPH STORY, COMMENTARIES ON THE LAW OF PARTNERSHIP 1 (photo. reprint 1980) (1841).

<sup>33</sup> Although the common law and the statutes provide for equal sharing, see U.P.A. § 18(a); U.P.A. § 401(b) (1994), 6 U.L.A. 51 (1995), they also contemplate contractual variations in sharing—a contemplation that is often fulfilled.



terest apart from the partnership's interest—i.e., except as his self-interest is embodied in his entitlement to share in the partnership's interest, or within the limited circumstances in which the other partners may validly consent.<sup>34</sup> In short, the sharing obligation does not entail departure from the exclusive benefit principle, although it does often require departure from the prophylactic prohibition.

Deterrent sanctions like constructive trusts, that are the hallmark of fiduciary obligations, may be invoked to restrain a partner from misappropriating partnership assets. But to the extent that a partner's accountability permits sharing (in accordance with the distributive terms of the partnership agreement) the misappropriated gains that are returned to the partnership, deterrent sanctions are diluted and fiduciary restrictions may, *pro tanto*, be deemed to be loosened.<sup>35</sup>

That loosening may be said to be a move in the direction of contract obligation and away from the fiduciary obligations associated with trustees and agents. The revisions proposed in the Revised Uniform Partnership Act contemplate further substantial loosening. But the Revised Uniform Partnership Act is authoritatively said not to assimilate such diluted partnership obligations to "mere" contract, even as it erodes fiduciary obligations.<sup>36</sup> Nor does the limited power of

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<sup>34</sup> See U.P.A. § 21(1) (1914), 6 U.L.A. 608 (1995). But see BROMBERG & RIBSTEIN, *supra* note 31, at § 6.07(h); Robert W. Hillman, *Private Ordering Within Partnerships*, 41 U. MIAMI L. REV. 425, 456-63 (1987).

<sup>35</sup> See *Prince v. Harting*, 2 Cal. Rptr. 545, 549 (1960); *Liggett v. Lester*, 390 P.2d 351, 355 (Or. 1964); BROMBERG & RIBSTEIN, *supra* note 31, at § 6.07(i); Leona Beane, *The Fiduciary Relationship of a Partner*, 5 J. CORP. L. 483, 502 n.141 (1980). But if a partner's behavior is "sufficiently egregious," punitive damages that do not entail sharing may be imposed. See BROMBERG & RIBSTEIN, *supra* note 31, § 6.07.

The loosening of restrictions may account for the admonitory piety of the courts in discussing partners' fiduciary obligations. See J.A.C. Hetherington, *Defining the Scope of Controlling Shareholders' Fiduciary Responsibilities*, 22 WAKE FOREST L. REV. 9, 11 (1987).

<sup>36</sup> The Revised Uniform Partnership Act focuses on the extent to which fiduciary obligations should be diluted or curtailed, and in any event should be waivable, but there is reluctance to permit them to be wholly eliminated by the parties. See U.P.A. §§ 103(b)3-5, 404 & cmts (1994), 6 U.L.A. 16, 58 (1995). Compare Allan W. Vestal, *Fundamental Contractarian Error in the Revised Uniform Partnership Act*, 73 B.U. L. REV. 523, 556-63 (1993) [hereinafter Vestal, *Contractarian Error*], and Donald J. Weidner, *Three Policy Decisions Animate Revision of Uniform Partnership Act*, 46 BUS. LAW. 427, 460-61 (1991), and Donald J. Weidner & John W. Larson, *The Revised Uniform Partnership Act: The Reporters' Overview*, 49 BUS. LAW. 1, 26-28 (1993), with Larry E. Ribstein, *The Revised Uniform Partnership Act: Not Ready for Prime Time*, 49 BUS. LAW. 45, 57-61 (1993). The elimination of all reference to "fiduciary" in the text, the content of § 404(e) and the standard of "good faith and fair dealing" in § 404(d) go a long way toward making the partnership relationship one of simple contract. See U.P.A. § 404(2). Compare Weidner & Larson, *supra*, at 18-20, 23-28, with Ribstein, *supra*, at 52-61. But the authors of the Revised Uniform Partnership Act insist they have not gone all the way. See Weidner & Larson, *supra*. But cf. Claire Moore Dickerson, *Is it Appropriate to Appropriate Corporate Concepts: Fiduciary Duties and the Revised Uniform Partnership Act*, 64 U. COLO. L. REV. 111 (1993); Allan W. Vestal, *The Disclosure Obligations of Partners Inter Se Under the Revised Uniform Partnership Act of 1994: Is the Contractarian*

partners to consent to particular departures from the looser fiduciary obligations, upon adequate disclosure of the import of such consent,<sup>37</sup> imply (or offer reason for) substitution of simply contractual restrictions on partners' self-serving behavior in the absence of such consent.

## B. Management's and Controllers' Fiduciary Obligations to Stockholders of Public Corporations<sup>38</sup>

### 1. Management<sup>39</sup>

When the fiduciary notion is examined in the context of the relationship of management of a public investor-owned corporation to

*Revolution Failing?*, 36 WM. & MARY L. REV. 1559, 1564 (1995) [hereinafter Vestal, *Disclosure Obligations*]. In view of the feasibility of obtaining the partners' meaningful consent to particular transactions, the insistence on eviscerating "background" fiduciary obligations is puzzling.

<sup>37</sup> There is considerable current debate on whether partners should be able to, or under existing law may, contract *wholly* or even substantially out of fiduciary obligations, see *supra* note 36; see also, BROMBERG & RIBSTEIN, *supra* note 31, §§ 6.01(c), 6.07(h), even though they may on occasion be permitted to grant broad waivers. See generally Daniel S. Reynolds, *Loyalty and the Limited Partnership*, 34 KAN. L. REV. 1 (1985) (discussing limited partnerships). See also ALFRED F. CONARD ET AL., ENTERPRISE ORGANIZATION 355-57 (4th ed. 1987) (illustrating one possibility that may or may not be valid). Permissible waivers are limited in scope, see Vestal, *Contractarian Error*, *supra* note 36, at 530 n.19. Like all forms of such consent (as in the cases of trust beneficiaries and commercial principals) these waivers are conditioned on meeting requirements of disclosure and volition. At common law and under the UPA, and to a lesser extent under the RUPA, such requirements are likely to be more demanding than under contract or tort doctrine. See BROMBERG & RIBSTEIN, *supra* note 31, § 6.06; Deborah A. DeMott, *Do You Have the Right to Remain Silent?: Duties of Disclosure in Business Transactions*, 19 DEL. J. CORP. L. 65 (1994) [hereinafter DeMott, *Duties of Disclosure*]; Vestal, *Disclosure Obligations*, *supra* note 36, at 1603-09, 1612.

<sup>38</sup> The posture of stockholder managers of typical close corporations vis-a-vis other stockholders is more like that of partners than managers of publicly held corporations. To be sure, the background legal characteristics of close corporations differ from those of partnerships—e.g., with respect to terminability and division of assets, participation in decision-making, liability of partners, and even transferability of participation. Increasing the extent of those differences by "contract" does not make the exclusive benefit principle and its prophylactic implementation less essential for close corporations than for partnerships. However, the ability freely and knowledgeably to alter those "fiduciary" obligations, which is greater for participants in close than in public corporations (although possibly less than for partners), may well be of more significance for participants of close corporations than of public corporations. Analysis of the interplay between the exclusive benefit principle and the power to waive it in the case of the close corporation entails somewhat different doctrinal and normative questions than are entailed in either typical private partnerships or public corporations. See, e.g., *Nagy v. Riblet Prod. Corp.*, 79 F.3d 572, 577 (7th Cir. 1996), *certifying questions* to 683 A.2d 37 (Del. 1996). As the "corporate" law learning infects the relationships among stockholders in close corporations, the equal sharing required of partners is transmuted into a requirement of "fairness" which is explicitly understood not necessarily to entail equal sharing. See, e.g., *Nixon v. Blackwell*, 626 A.2d 1366, 1376-77 (Del. 1993) (en banc). Compare *Donohue v. Rodd Electrotape, Inc.*, 328 N.E.2d 505, 518 (Mass. 1975), with *Zimmerman v. Bogoff*, 524 N.E.2d 849, 855 (Mass. 1988), and *Wilkes v. Springside Nursing Home, Inc.*, 353 N.E.2d 657, 663 (Mass. 1976).

<sup>39</sup> The concept "management" sometimes refers to the Board of Directors [hereinafter

the enterprise and the holders of its common stock, a still different configuration of interests and needs must be addressed. Management's fiduciary obligations of loyalty, although perhaps not formally attributable to the agency concept, are substantially the same as those of agents.<sup>40</sup> Those duties are sometimes said to run to the corporation, sometimes to the stockholders (generally the common stockholders) and sometimes to both.<sup>41</sup> In any event, management's duty of loyalty requires the same self-denying behavior on its part, whether its duty is owed to the corporation or to the common stockholders. Traditional fiduciary loyalty obligations would forbid management from benefiting

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"board"] (generally elected by the stockholders), sometimes to the officers (generally appointed by the board) and sometimes to both. For purposes of this paper it is unnecessary to distinguish between the board and the officers, notwithstanding that (a) board members function only episodically and receive modest compensation in comparison with executive officers, and (b) some board members may not be engaged in transactions that violate the exclusive benefit principle, or indeed that those members may "consent" (on behalf of "the corporation" or the stockholders) to such transactions. The term "management" will refer to both in discussing conduct that implicates their duty of loyalty.

<sup>40</sup> A more or less formal problem is generated by the ambiguous roles of the board and the officers since they are undoubtedly viewed as agents of "the corporation" for purposes of relating "the corporation" to third persons. Neither is formally an agent of the inert fictitious principal which cannot possibly "control" them. On the contrary, in their respective roles, each controls the principal. Nor is either formally an agent of the stockholders, who are powerless to control their conduct in operating the business. But, if the demands of centralized management thus restrict stockholder power, nothing in those demands alters the obligations of officers and directors to act with the care in managing the business that attaches to agents acting on behalf of the stockholders who selected the board and, indirectly, the officers. More importantly, nothing in those demands requires altering the obligations of loyalty, including the exclusive benefit principle, that attaches to agents and trustees. Nor is there any divergence between the legitimate interests of the stockholders and those of the abstraction denominated "corporation" in management's loyalty, notwithstanding divergences and conflicts of interest among "the corporation's" investors in the matter of maximizing or indeed preserving the value of the collective assets. See *infra* Part II.

<sup>41</sup> The interests of the corporation as a fictitious entity inevitably convert into the interests of the constituents or participants in the enterprise that is conducted in the form of the corporation. As a matter of social and economic policy, there is room to argue about the allocation of entitlements and obligations among those participants or "stakeholders," and doctrinally, comparable questions arise by reason of their contractual arrangements. See *supra* note 13; Chapman, *supra* note 11. But, by definition, fiduciary loyalty obligations that entail the exclusive benefit principle for one set of claimants cannot run from management to each of the conflicting claimants. There are sound, if debatable, economic reasons for the corporate structure to empower common stockholders (both because they only take residual risks and because of their inability adequately to specify or monitor threats to their residual interest), rather than any of the other constituencies, to vote for management (i.e., the decision makers). See Jonathan R. Macey, *An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties*, 21 STETSON L. REV. 23 (1991); Jonathan R. Macey, *Externalities, Firm-Specific Capital Investments, and the Legal Treatment of Fundamental Corporate Changes*, 1989 DUKE L.J. 173, 179-88; see also Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 403-06 (1983). Those reasons and the accompanying structure imply that management's agency or fiduciary obligations should run to stockholders rather than to the others. See *infra* notes 63-69 and accompanying text.

itself (except for specified compensation) in dealing with corporate assets, the corporation or the stockholders, and require it to direct its energies to benefiting solely the corporation and *pro tanto* the stockholders.

The public stockholder, like the commercial principal and the partner, seeks increase in the value of his or her investment. The virtues of centralized management in effecting that goal preclude both officers and directors from being subject to the daily control of stockholders, as a commercial agent in such matters might be. Moreover, the wealth-enhancing function of management implicates taking risks with the assets that are not permitted to a trustee. But neither the reasons for centralized management nor for the risk-taking function of management preclude binding both officers and directors with the fiduciary's traditional obligation of loyalty. If management's temptation to self-aggrandize is strong, the restraints imposed by reputation considerations do not seem equally strong—or at least any stronger than in the case of trustees or commercial agents or partners.

The public stockholder is considerably more in need of the exclusive benefit principle and its prophylactic implementation to protect against self-serving behavior by management than a partner (at least an active partner) or an individual principal in the typical commercial context is likely to be. The stockholder, like the settlor of a trust, is unable to specify the opportunistic behavior against which he or she needs protection and is not much more able than the trust beneficiary to monitor the decisions being made under such restrictions or enforce compliance with those terms. Nor does the public stockholder have the capacity of a commercial principal to specify limits, monitor management, select officers or threaten, much less terminate, their tenure. And while in theory stockholders elect "independent" directors to perform those functions, the latter are likely to owe their selection more to managers than to stockholders and are not easily removable by stockholders.

No less significant, in the context of investor-owned public corporations, the notion of "consent" by the stockholders to departure from the exclusive benefit principle is a problematic construct, whether given *ex ante* in general terms or *ex post* by way of voting approval of a specific transaction. If not entirely a fiction, it is a far cry from the actual consent that may be given by a settlor of a trust, a commercial principal or a participating partner.<sup>42</sup>

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<sup>42</sup> The stockholders' relationship with management's self-serving behavior or conflicts of interest does not easily fit into the contractual mold. At best, directors, not stockholders, negotiate officers' contracts on behalf of "the corporation." If consent is given by some "disinterested"

American corporate law has addressed both the matter of the rigor of the fiduciary strictures and the problem of stockholder consent to departure from them. Over the course of the last century, although the conditions underlying the historic application of the exclusive benefit principle and its prophylactic implementation in the corporate context have not changed materially,<sup>43</sup> the principle has been abandoned, notwithstanding the continued characterization of management's relationship and obligations to the enterprise and its stockholders as fiduciary. As the legal doctrine has evolved, the restrictions on managerial conduct no longer prophylactically forbid self-aggrandizing behavior. Although the exclusive benefit principle is not formally rejected,<sup>44</sup> the governing doctrine effects its rejection in part by the ease with which it finds stockholder consent to its avoidance by "disinterested" directors or dispersed stockholders, and in part, by its concept of "fairness."<sup>45</sup> To the extent that the formally required consent

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directors to self-serving activity by officers or other directors, the notion that "the corporation" is consenting simply imputes a will to the abstraction by reason of the acts of "disinterested" directors. Stockholders need not be, and generally are not, consulted or involved in such consent. If dispersed stockholder consent is sought, its actuality is clouded because there is little basis for finding either the negotiations or the cognition or volition that characterize the classic conception of consent that contract law enforces. See *infra* notes 76, 113-14.

The institutional investor is apt to be much less vulnerable than the individual investor in such matters, particularly where *ex post* approval of a specified transaction is concerned, but its consent is not remotely comparable to that of an active partner or commercial principal. Not only does its management's relationship with managements of portfolio companies implicate interests that diverge from its stockholders' interests in monitoring loyalty, but institutional investors, particularly mutual funds, often do not have a large enough or continuous enough interest in any particular portfolio company to justify the costs of engagement in specifying or monitoring the loyalty terms of their investment. See generally Keith C. Brown et al., *Of Tournaments and Temptations—An Analysis of Managerial Incentives in the Mutual Fund Industry*, 51 J. FIN. 85 (1996); John C. Coffee, Jr., *The Institutional Investor As Corporate Monitor*, 91 COLUM. L. REV. 1277 (1991); Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445 (1991). Moreover, notwithstanding recent changes in the proxy rules, the willingness and power of institutional investors to collaborate in order to overcome collective action difficulties are problematic. See Bernard S. Black & John C. Coffee, Jr., *Hail Britannia? Institutional Investor Behavior Under Limited Regulation*, 92 MICH. L. REV. 1997, 2055-77 (1994). But cf. Dean Strickland et al., *A Requiem for the USA—Is Small Shareholder Monitoring Effective?*, 40 J. FIN. ECON. 319 (1996).

<sup>43</sup> Whether or not that implementation was as extensively invoked in restraining corporate management and controllers as Marsh suggested, there is no doubt that it was pervasive, particularly in industrial states. Compare Harold Marsh, Jr., *Are Directors Trustees?*, 22 BUS. LAW. 35 (1966), with Norwood P. Beveridge, Jr., *The Corporate Director's Fiduciary Duty of Loyalty: Understanding the Self-Interested Director Transaction*, 41 DEPAUL L. REV. 655 (1992).

<sup>44</sup> Compare MODEL BUS. CORP. ACT § 8.31(a) cmt. 1 (1986) (section withdrawn 1988); MODEL BUS. CORP. ACT § 8.61(b)(3) (1996); PRINCIPLES OF CORP. GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 5.02 & cmts. (1992). Legislation that authorizes management to take into account the interests of other stakeholders qualifies the scope of the exclusive benefit principle and its import to prefer the interests of common stockholders over other stakeholders.

<sup>45</sup> Statutes do not contain a prophylactic prohibition against self-dealing, but often prescribe,

need not be adequately informed or volitional,<sup>46</sup> and the test of fairness permits the fiduciary to obtain some or all of the gain from self-dealing for itself, the restrictions on self-aggrandizement are not simply looser than required by traditional fiduciary notions, but they tend to become invisible.

Moreover, the role of the court in reviewing challenges to a particular claim of consent or fairness contemplates (and embodies) little critical assessment of the actuality of the consent and little more check on managerial determination of such "fairness."<sup>47</sup> Notwithstanding oc-

or sometimes permit but do not prescribe, a test of fairness in the absence of informed consent. See, e.g., DEL. CODE ANN. tit. 8, § 144 (1991); ME. REV. STAT. ANN. tit. 13-A, § 717(1)(c) (West 1964); N.Y. BUS. CORP. LAW § 713 (McKinney 1986); MODEL BUS. CORP. ACT § 8.61(b)(3) (1996). But see CAL. CORP. CODE § 310(a)(3) (West 1990) (requiring fairness as well as disclosure and approval). Sometimes informed consent excuses the fairness requirement. See N.J. STAT. ANN. § 14A:6-8 (West 1969); see also *Williams v. Geier*, 671 A.2d 1368, 1377-80, 1384 (Del. 1996); *Oberly v. Kirby*, 592 A.2d 445, 466 (Del. 1991) (rehearing en banc); *Ryan v. Tad's Enter.*, Nos. CIV.A.10229, 11977, 1996 WL 204502, at \*5-14 (Del. Ch. Apr. 24, 1996); Douglas M. Branson, *Assault on Another Citadel: Attempts to Curtail the Fiduciary Standard of Loyalty Applicable to Corporate Directors*, 57 *FORDHAM L. REV.* 375, 385-90 (1988); Ahmed Bulbulia & Arthur R. Pinto, *Statutory Responses to Interested Directors' Transactions: A Watering Down of Fiduciary Standards?*, 53 *NOTRE DAME L. REV.* 201 (1977). PRINCIPLES OF CORP. GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 5.02 (1992) makes the disinterested directors' consent sufficient if given to a transaction they reasonably believe is fair (rather than *is* fair), and the stockholders' consent is sufficient if the transaction is not wasteful, even though it may be unfair.

<sup>46</sup> Such consent may be given in the corporate charter, which raises serious problems as to disclosure. See, e.g., *Spiegel v. Beacon Participations, Inc.*, 8 N.E.2d 895, 907 (Mass. 1937); *Everett v. Phillips*, 43 N.E.2d 18, 20 (N.Y. 1942). In any event, the scope of the required disclosure is increasingly being limited by statute. Compare MODEL BUS. CORP. ACT §§ 8.60(4) cmt. 4, 8.62(b) & cmt. 2 (1996), with PRINCIPLES OF CORP. GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 5.02(a)(1) & cmts. (1992). Approval of the transaction must be given by disinterested directors and sometimes by disinterested stockholders. The relationships which satisfy the "disinterested" director requirement do not suggest a critical (let alone conventional contractual adversarial) stance toward the self-dealing director whose transactions the "disinterested" directors are asked to approve. See, e.g., MODEL BUS. CORP. ACT §§ 8.31, 8.60 & cmts. (1996); PRINCIPLES OF CORP. GOVERNANCE: ANALYSIS AND RECOMMENDATIONS §§ 1.23, 1.34 (1992); David Yermack, *Good Timing: CEO Stock Option Awards and Company News Announcements*, 52 *J. FIN.* 449, 450-54 (1997). The absence of such a stance is not offset by either the manner of selection of the "disinterested" director (whose selection generally requires the CEO's approval) or by attitudes likely to be generated in their normal occupation (which often is that of executives or retired executives of comparable corporations). Nor is the mode and amount of their compensation likely to sharpen their critical view. It does not detract from this conclusion that "disinterested" directors may reflect shareholder interest more faithfully than "interested" directors. Compare Laura Lin, *The Effectiveness of Outside Directors as a Corporate Governance Mechanism: Theories and Evidence*, 90 *Nw. U. L. REV.* 898, 904-05 (1996), with Lynne L. Dallas, *The Relational Board: Three Theories of Corporate Boards of Directors*, 22 *J. CORP. L.* 1, 18-22 (1966), and Sanjai Bhagat and Bernard S. Black, *Do Independent Directors Matter?* (1996) (manuscript on file with *Boston College Law Review*).

<sup>47</sup> In the case of unilateral appropriation without formal consent, management must generally establish that the result of the transaction was fair to the corporation. See, e.g., N.Y. BUS. CORP. LAW § 713 (McKinney 1986); MODEL BUS. CORP. ACT § 8.61(b)(3) (1996); PRINCIPLES OF CORP.

casional pious allusions to the exclusive benefit principle in opinions,<sup>48</sup> the surviving body of corporate fiduciary doctrine has lost that principle's normative underpinning.<sup>49</sup> Apart from occasional references to the "market" as benchmark, it offers murky and permeable limits on management's self-aggrandizing behavior and serves more as an admonitory ghost that hovers than a substantive proscription.

Possibly the dilution of fiduciary loyalty strictures in the context of corporate management responds to perceptions of lesser need (because of the restraining influence of market pressures and reputational concerns) and of larger net costs of over-prohibiting than in the cases of agency and trusts or partnership. But the perceptions of lesser need or greater cost<sup>50</sup> are hard to justify. Moreover, the benefits to stockhold-

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GOVERNANCE: ANALYSIS AND RECOMMENDATIONS §§ 5.02(b), 5.04(b) (1992). In the case of managerial appropriation to which stockholders or disinterested directors have consented, the lack of fairness or the presence of waste must generally be demonstrated in court by the challenger. *See* N.Y. BUS. CORP. LAW § 713; MODEL BUS. CORP. ACT § 8.61(b)(3); PRINCIPLES OF CORP. GOVERNANCE: ANALYSIS AND RECOMMENDATIONS §§ 5.02(b), 5.04(b). The challenger's burden is even heavier when courts fail to see a loyalty problem and invoke the business judgment rule or focus on whether the procedure by which the transaction was negotiated and executed was fair and scant the issue of substantive fairness. *See, e.g., Williams*, 671 A.2d at 1384; *Kamin v. American Express Co.*, 383 N.Y.S.2d 807, 811-12 (Sup. Ct.), *aff'd*, 387 N.Y.S.2d 993, 993 (App. Div. 1976); *cf. In re Wheelabrator Techn., Inc.*, 663 A.2d 1194, 1200 (Del. Ch. 1995) (controlling stockholder in merger). In any event, the judicial notion of substantive "fairness" appears to tolerate considerable overreaching. *Compare, e.g., Kahn v. Lynch Communication Sys., Inc.*, 669 A.2d 79, 84 (Del. 1995), *with Kahn v. Lynch Communication Sys., Inc.*, 635 A.2d 1110, 1115-17 (Del. 1994); *compare also Rabkin v. Phillip A. Hunt Chem. Corp.*, 498 A.2d 1099, 1105, 1107-08 (Del. 1985), *with Rabkin v. Olin Corp.*, Fed. Sec. L. Rep. (CCH) ¶ 95,255 (Del. Ch. 1990).

A less demanding test that focuses on easily met formal requirements obtains in the case of MBOs and in the case of defensive maneuvers against possible or proposed take-overs. The results that the "enhanced" (in contrast to "strict") judicial scrutiny that the opinions require is little more critical than judicial review of management's business judgment. *Compare* Marcel Kahan, *Paramount or Paradox: The Delaware Supreme Court's Takeover Jurisprudence*, 19 J. CORP. LAW 583 (1994), *with the "stories" discussed in Edward B. Rock, Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 U.C.L.A. L. REV. 1009 (1997).

<sup>48</sup> *See, e.g., Bailey v. Jacobs*, 189 A.2d 320, 324 (Pa. 1937); *Klinicki v. Lundgren*, 695 P.2d 906, 910 & n.2 (Or. 1985).

<sup>49</sup> The dilution of management's fiduciary obligations of loyalty extends beyond self-dealing transactions to other forms of self-aggrandizement. *See Cellular Info. Sys., Inc. v. Broz*, 663 A.2d 1180, 1184-85 (Del. Ch. 1995); PRINCIPLES OF CORP. GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 5.05 (1992).

<sup>50</sup> *E.g.*, transaction costs for a firm in dealing with strangers instead of with management or controllers (the cost of obtaining information, negotiating, risk assessment, etc.)—and the cost of lost transactions in which the executive or director or controller is the sole source or the cheapest source of a good or service that the corporation is thought to require.

In all types of transactions by managers or controllers of publicly held corporations with their stockholders or corporations it is theoretically possible that both parties will gain. Some transactions are so laden with potential for gain for the former and loss for the latter, temptation for the former to realize the gain and difficulty in policing, that only the exclusive benefit principle can systematically assure the stockholders against loss. Whether categorical prohibition of trans-

ers of self-aggrandizing conduct by managers, if real, can be obtained by consent; and because the consent required from stockholders or their "agents" (disinterested directors) is largely fictitious and readily obtained, the reluctance to continue background prophylactic restrictions on self-aggrandizing behavior by officers and directors of public corporations is something of a puzzle. So too is the movement of doctrine in the direction of looser (or indeed abandonment of) restrictions of fairness if such consent is obtained.<sup>51</sup>

Possibly the notion is that management's overt compensation is insufficient, and management of publicly held corporations will not do its job unless it has the added incentive of indeterminate interest in the residual returns from self-aggrandizing transactions; possibly, those returns will avoid the need ultimately to adjust management's overt compensation. That certainly is a dominant strand in theories offered to justify management insider trading and buy-outs.<sup>52</sup> The social cost of thus relaxing traditional fiduciary proscriptions is said to be minimal because stockholders expect it in public corporations; and, with liquid markets for their stock, stockholders are said to be able to diversify the risk of "improper" managerial self-aggrandizing conduct and thus to make such conduct less costly to them.<sup>53</sup>

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actions from which both sides might gain, in the interest of protecting one side against the high likelihood of systematically losing, is "worth" it poses empirical questions and the essential normative question.

Similar problems are presented by the claim that the exclusive benefit principle dampens the incentives of managers, who are said to need the incentives of gains from self-dealing in order to do their best for the stockholders.

<sup>51</sup> See, e.g., MODEL BUS. CORP. ACT §§ 8.60-63 & cmts. (1996); PRINCIPLES OF CORP. GOVERNANCE: ANALYSIS AND RECOMMENDATIONS §§ 5.02 & cmts., 5.05 & cmts. (1992). That result may reflect the special cost that would be incurred by public corporations because of potentially perverse litigation incentives. Non-compliance with a requirement of consent to departure from easily identified prophylactic restrictions could be challenged by nuisance suits (driven by lawyers for dispersed stockholders, whose only interest is in the fee) in cases in which principals or partners with a more substantial stake would (or would not) knowledgeably waive non-compliance. See Davis, *supra* note 3, at 49-52.

<sup>52</sup> See, e.g., Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857, 866-72 (1983). Studies of management buyouts suggest higher returns to the enterprise, presumably as a result of management's enhanced incentives. However, there is no good measure of the extent to which those increased returns are (1) implicit in the enterprise (without any need for added effort by management) but unknown to public investors who are bought out, or (2) attributable to contributions by the persons financing the buy-out by way of new ideas, new capital or better monitoring of management. For analysis and review of the evidence on the efficiency of management buyouts, see RONALD J. GILSON & BERNARD S. BLACK, *THE LAW AND FINANCE OF CORPORATE ACQUISITIONS* 398-429 (2d ed. 1995). In either case, cashed out stockholders may have a better claim to share in the resulting increased values than does management. Cf. *Cede & Co. v. Technicolor, Inc.*, 684 A.2d 289, 298-99 (Del. 1996).

<sup>53</sup> It is not self-evident that the benefits of diversification of risk are obtainable when the



That agency costs are inevitable does not preclude efforts to reduce them. There is room to debate the questions implicit in those efforts. Empirical evidence on the quantifiable net gains or losses to the parties or society from the exclusive benefit principle is difficult to obtain.<sup>54</sup> In the absence of such evidence, the question is not answered by reference to "contract" as a relevant process, by antiseptic economic models, or by speculation about how rational wealth-maximizing actors in them (even when organized as institutional owners)<sup>55</sup> would perform, any better than by intuitions about (and experience with) the acquisitive behavior of management.<sup>56</sup> The exclusive benefit principle is a normative response to long experience in such matters. It is not readily apparent how the erosion of that principle over the last century did (or a shift to "contract" as a norm would) result in net economic benefits to investors or to society. Moreover, as we have noted, values other than utilitarian concerns are entailed in classic fiduciary restrictions—whether imposed upon management or controllers or trustees or agents.

Whatever the reasons for relaxing the restrictions on management's appropriative behavior, a curtain of fiduciary discourse still screens the loosened strictures. The fiduciary rhetoric of courts may have an impact on investors' expectations; but these expectations are hardly fulfilled by the modest effect of such admonitory rhetoric on

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variable diversified is risk of management misappropriation. But even if some such benefits are obtainable, unless the terms of engagement on those premises are clarified and the scope of management's permissible self-aggrandizing behavior is made explicit, the appropriate cost-benefit analysis must be made in terms of the relationship of shepherd to sheep.

<sup>54</sup> E.g., how measure the extent and cost of transactions lost by invoking the principle or its prophylactic implementation? Is the cost to be sustained from offering management the added incentive that comes from self-dealing greater than the cost of more explicit modes of compensation? How measure the costs to stockholders and litigation costs to society of the theoretical indeterminacy and practical porosity of a standard of "fairness"? Second order consequences also are hard to measure—e.g. Will the cost of the relaxed stricture and increased returns to management, in a world in which investors understand the fact and risks of such relaxation result in higher charges for capital? Is that cost preferable to the cost of the higher level of fees that management would charge or reduced efforts it would extend, if the strictures were not relaxed? See generally Davis, *supra* note 3.

<sup>55</sup> The monitoring role of institutional owners on management's efficiency is unclear. See *supra* note 42. However effective it may be to energize displacement of management if economic disaster occurs, there is little evidence on effectiveness of such monitoring in non-crisis situations. Its impact on the duty of loyalty is even less clear.

<sup>56</sup> A *priori* analysis suggests little loss from a prophylactic rule. Compare ROBERT CHARLES CLARK, CORPORATE LAW § 5.4.2 (1986), with Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J.L. & ECON. 425, 442 (1993). And there is reason to doubt the teaching of economic models that argue for looser restrictions on managerial self-aggrandizement. See Lucian Arye Bebchuk & Christine Jolls, Managerial Value Diversion and Shareholders Wealth (Feb. 1996) (unpublished discussion paper no. 179, on file with the *Boston College Law Review*).

legally permissible or actual appropriative behavior.<sup>57</sup> Possibly, as we shall see, although it rarely offers any determinate restrictions or any rationale for relaxing the classic prohibitions, that rhetoric implicates tighter limits on such behavior than does the diction of classic contract doctrine.<sup>58</sup>

## 2. Controllers

Dilution of the exclusive benefit principle for delineating management's fiduciary obligations of loyalty is matched in the relaxation of restrictions on self-aggrandizing behavior by controlling stockholders ("controllers"), particularly parent corporations, notwithstanding the imputation to them of fiduciary obligations.<sup>59</sup>

To be sure, unlike management, controllers' function does not formally entail performing services or operating or managing corporate assets as delegates of, and for the *sole* benefit of, public investors. But when controllers exercise their power to influence management's decisions in corporate affairs, they are effectively directing choices in operation of the common assets on which public stockholders have a pro-rata claim—i.e., structurally they are vested with power thus to act on behalf of the stockholders in managing the common enterprise.

In the exercise of that power, controllers' fiduciary obligation precludes their obtaining separate benefits for themselves—except as specified compensation for services is provided. Their obligation is to benefit all the stockholders collectively even if they cannot act *solely* for the benefit of public stockholders because, unlike management, they

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<sup>57</sup> Cf. Robert C. Clark, *Agency Costs Versus Fiduciary Duties*, in PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS 55, 75–76 (John W. Pratt & Richard J. Zeckhauser eds., 1985). It is worth recalling in the context of such discourse that two decades ago, academics suggested that the laxity and increasingly porous character of state fiduciary restrictions on managers' and controllers' self-benefiting conduct be remedied by federal legislation. See William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663, 696–705 (1974); Marvin A. Chirelstein, *Towards a Federal Fiduciary Standards Act*, 30 CLEV. ST. L. REV. 203 (1981). Nothing that has happened in the interim suggests diminished need for a remedy for such porosity.

<sup>58</sup> See *infra* notes 89–107 and accompanying text.

<sup>59</sup> Controlling stockholders have neither less power nor significantly less temptation than does management to divert to themselves portions of the corporate assets at the expense of public stockholders. Unlike management, the rational controller has the same risk-return incentives as the remaining stockholders in making investment or operating decisions—except as it is effectively diverting assets to itself. Cf. *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 721–22 (Del. 1971). In the absence of some check on the controller's power to divert, the uncertainties faced by public investors would wastefully raise the cost of capital. The same considerations that support the strictures of loyalty on officers and directors support comparable, but not identical, strictures on controllers.

are themselves participants in ownership and entitled as such to share that benefit with the others. Like partners, their share of gains from such activity is appropriately limited to their proportionate interest in the enterprise.<sup>60</sup> As with partners, this is an adaptation of the exclusive benefit principle that precludes any *separate* gain for the fiduciary and requires return of *all* gain by the controllers to the collective, but entitles the controllers to their proportionate share as owners.

Appropriative behavior by controllers or by parent corporations in intercompany transactions with subsidiaries, as by management in dealing with its corporation, is currently not restricted by prophylactic prohibitions or the exclusive benefit principle,<sup>61</sup> even if it was so restricted historically. On the other hand, sharing (more than occasionally on the basis of equality per share) seems to be embedded in the "fairness" requirement for self-aggrandizing transactions, including those to which prophylactic prohibitions cannot easily apply, like mergers,<sup>62</sup> or sales of con-

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<sup>60</sup> The doctrinal sources of the criterion of proportionate sharing (or equal sharing per share) by controlling stockholders are to be found in state statutes, corporate charters and the general understanding of the investment community. Equality of distribution per share is fundamental to the meaning of the concept of a "class" of stockholders and to valuing shares of stock by reference to the firm's aggregate cash flow or net earnings or assets; and it is so pervasive in the atmosphere of investing and trading in shares of stock that imputing investor consent to any arrangement other than equal distribution of, for example, dividends per share, is difficult in the absence of express provision therefor. Cf. *Friedman v. Beway Realty Corp.*, 661 N.E.2d 972, 975-76 (N.Y. 1995).

Although forms of distribution other than dividends or liquidation—e.g., realignment of participations by merger or recapitalization—are no less subject to fiduciary restrictions, the equality of treatment principle is often rejected by the courts in those other contexts. See, e.g., *infra* notes 62-66. Such rejection does not purport to distinguish between "contract" and "fiduciary" considerations as the authority therefor. Nor does it offer any meaningful measure of the extent of permissible departure from equality—notwithstanding that fiduciary obligations should thus restrict the controller more narrowly than would "mere" contract obligations, which would permit it to seek to favor its own interests over those of other stockholders. See *infra* text accompanying notes 93-97.

<sup>61</sup> See, e.g., *International Radio Tel. Co. v. Atlantic Communications Co.*, 290 F. 698, 701-02 (2d Cir. 1923); *Sinclair Oil Corp.*, 280 A.2d at 720; *In re Wheelabrator Techn., Inc.*, 663 A.2d 1194, 1203 (Del. Ch. 1995); *Puma v. Marriott*, 283 A.2d 693, 695 (Del. Ch. 1971); *Ewen v. Peoria & Eastern Ry. Co.*, 78 F. Supp. 312, 316-17 (S.D.N.Y. 1948).

<sup>62</sup> The cases leave some uncertainty as to the reach of the sharing principle in defining fiduciary restrictions on controllers. See, e.g., John C. Coffee, Jr., *Transfers of Control and the Quest for Efficiency: Can Delaware Law Encourage Efficient Transactions While Chilling Inefficient Ones?*, 21 DEL. J. CORP. L. 359, 362-63 (1996). In parent-subsidiary mergers (both cash-out and stock-for-stock types), for example, courts (1) often invoke fiduciary terminology and the notion of rescission and rescissory damages, and (2) permit valuation by reference to premiums paid in comparable transactions—both of which suggest some kind of sharing, possibly on an equal basis per share. See *Lynch v. Vickers Energy Corp.*, 429 A.2d 497, 501 (Del. 1981), modified, *Weinberger v. UOP, Inc.*, 457 A.2d 701, 714 (Del. 1983); see also *In re Tri-Star Pictures, Inc.*, 634 A.2d 319, 333-34 (Del. 1993). But cf. *Williams v. Geier*, 671 A.2d 1368 (Del. 1996). Proportionate sharing

trol<sup>63</sup> or other transactions involving control.<sup>64</sup> Judicial opinions sometimes suggest that public stockholders formally consent to departure from the norm of equality by controllers but the reality of that consent is doubtful.<sup>65</sup>

The conditions that drive the doctrinal loosening of restrictions on controllers appear to be that exclusive benefit and proportionate sharing principles impose more net costs on public corporations and

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is also suggested in other transactional settings. See, e.g., *Lebold v. Inland Steel Co.*, 125 F.2d 369, 375 (7th Cir. 1941) (involving freeze-out merger of minority shareholders); *Coggins v. New England Patriots Football Club, Inc.*, 492 N.E.2d 1112, 1119 (Mass. 1986) (involving freeze-out merger of non-voting public shareholders); *Berkowitz v. Power/Mate Corp.*, 342 A.2d 566, 574 (N.J. Super. Ct. Ch. Div. 1975) (involving freeze-out merger of minority public shareholders). In others, the courts talk of public stockholders being "fairly" treated if the value of their "get" in the merger equals the value of their "give," computed on DCF pre-merger gains basis that may take no account of the enterprise's imminent potential of synergistic gains from combining with the acquirer. See *Rosenblatt v. Getty Oil Co.*, 493 A.2d 929, 940 (Del. 1985). But cf. *Cede & Co. v. Technicolor, Inc.*, 684 A.2d 289, 298-99 (Del. 1996) (*Cede & Co. II*). That approach suggests the possibility of no sharing at all and allocation of all gain to the controller. The ambiguous scope of "fairness" in such transactions is illustrated by a comparison of the two Delaware Supreme Court decisions in the *Kahn v. Lynch Communications Systems* litigation and the *Rabkin* litigation. See *supra* note 47; see also *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 371-72 (Del. 1993) (*Cede & Co. I*).

Many cases dealing with minority discounts suggest an equal treatment requirement, but they are not entirely consistent among themselves and they are less than consistent with cases dealing with premiums on sale of control, particularly in appraisal proceedings. Compare *Cede & Co. II*, 684 A.2d at 298-99, and *Cavalier Oil Corp. v. Harnett*, 564 A.2d 1137, 1144-45 (Del. 1989), and *Friedman v. Beway Realty Corp.*, 661 N.E.2d 972, 977 (N.Y. 1995), with *Rapid-American Corp. v. Harris*, 603 A.2d 796, 806 n.2 (Del. 1992). See generally John C. Coates IV, Fair Value as a Default Rule of Corporate Law: Minority Discounts in Conflict Transactions (unpublished manuscript, on file with *Boston College Law Review*).

<sup>63</sup> Sales of control, unaccompanied by a merger with the acquirer, appear generally not to require sharing, but to require proportionate sharing if courts perceive undue potential for mulcating public shareholders in particular transactions. See generally Einer Elhauge, *The Triggering Function of Sale of Control Doctrine*, 59 U. CHI. L. REV. 1465 (1992). But see Coffee, *supra* note 62.

<sup>64</sup> See, e.g., *Jones v. H.F. Ahmanson & Co.*, 460 P.2d 464, 476 (Cal. 1969) (en banc).

Fairness sometimes, but not often, prevents controllers from gaining unequal returns per share in the contexts of allocation of tax gains between parent and subsidiary. Compare, e.g., *In re Bob Richards Chrysler-Plymouth Corp.*, 473 F.2d 262, 263-65 (9th Cir. 1973), and *Alliegro v. Pan American Bank*, 136 So. 2d 656, 657-62 (Fla. Dist. Ct. App. 1962), with *Meyerson v. El Pasa Natural Gas Co.*, 246 A.2d 789, 792-94 (Del. 1967), and *Case v. New York Cent. R.R.*, 204 N.E.2d 643, 645-47 (N.Y. 1965). See also PRINCIPLES OF CORP. GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 5.11(a)(2) (1994).

Disclosure requirements in repurchase transactions (whether made for control purposes or otherwise) effectively implicate proportionate sharing. See *Lynch v. Vickers Energy Corp.*, 429 A.2d 497, 503-04 (Del. 1981), modified, 457 A.2d 701 (Del. 1983).

<sup>65</sup> Formal consent may be said to be given when approval of a majority of the minority public shareholders is obtained, see e.g., *Weinberger v. UOP Inc.*, 457 A.2d 701, 709 n.7 (Del. 1983), but the substance of such consent does not equate it with the knowledgeable and volitional consent of individual actors. See *supra* note 42.

their controllers than on partnerships or agents. Rejection of those principles is necessary to permit controllers to have the incentives to increase the value of the common enterprise and thereby presumably the value of the public stockholders' interest.<sup>66</sup> As with the loosened restrictions on management, this premise is debatable. *A priori*, a parent corporation's power and incentive to overreach public stockholders in its subsidiary in intercompany dealings seems to be more extensively usable and more costly than that of managers in self-dealing. Moreover, the constraining influence of reputation considerations is considerably less, as is also the likelihood of meaningful stockholder (including institutional stockholder) disapproval by action of "independent" directors or otherwise.<sup>67</sup> Categorical prohibition of such departures from proportionate treatment may (or may not) be less costly than permitting them. The argument for such departures rests on disputable behavioral assumptions<sup>68</sup> and requires empirical inquiries that are difficult to make.<sup>69</sup>

However valid may be the reasons for abandonment of the exclusive benefit and proportionate sharing principles in corporate law, the problem remains of finding criteria for determining the limits of man-

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<sup>66</sup> See, e.g., EASTERBROOK AND FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW*, chs. 4, 5 (1991). See also *infra* note 111 and accompanying text.

<sup>67</sup> The possibility that the rigors of those obligations may be tempered and their costs lessened by consent to deviation from them in particular transactions is no less present than in the case of partners and agents. Indeed, obtaining "consent" from dispersed shareholders is plainly less of an obstacle to approved departure from those obligations than is obtaining the consent of partners or commercial principals.

<sup>68</sup> See *infra* notes 111-14 and accompanying text.

<sup>69</sup> Arguably self-dealing between parent and subsidiary can produce more benefits in many kinds of transactions. But it may produce more harm in other kinds of transactions than similar dealings between management or an individual controller and its corporation. Reputation considerations are likely to impose fewer restraints on parent corporations than on individuals. In any event, the impact of such considerations on imposition of a prophylactic prohibition does not detract from the need for the exclusive benefit principle.

To assess the incentive value of encouraging or permitting a controller to self-deal or appropriate a disproportionate share of corporate assets implicates (as with management) weighing the net costs that tighter fiduciary restrictions might impose against the net costs of the more porous restrictions that have evolved. *A priori*, it is hard to envision any need to compensate a controller for going private or a parent for discovery costs in deciding to absorb a subsidiary, or indeed for added risk in undertaking the absorption. To be sure, differences in context (e.g., absorption of a subsidiary by a long-term controller in contrast to absorption by a recent take-over acquirer or by a recent private buyer of control) implicate differences in the need for, or power of, incentives for the controller to acquire 100% of the subsidiary. Comparable considerations affect determinations of fairness and of equal or proportionate treatment requirement; for instance an arms-length tender offer price may be a "fair" payment to a minority in a subsequent merger that is part of a unitary acquisition. *But cf.* *Zirn v. VLI Corp.*, 621 A.2d 773, 783 (Del. 1993).

agers' and controllers' appropriative behavior.<sup>70</sup> Debate on this problem and the accompanying arguments about the costs and benefits of management's and controllers' appropriating corporate values for themselves raises the question whether restraints on managers or controllers are, or should be, planted in the soil of contract<sup>71</sup> rather than in fiduciary ground. Courts' and legislatures' alteration of the structure of the loyalty obligations of corporate management and controllers by making them less restrictive than the traditional fiduciary obligations of trustees and agents does not answer those questions. Nor does the difficulty in separating the restrictions imposed by "mere" contract from those imposed by diluted corporate fiduciary notions by a bright line<sup>72</sup> preclude analysis of the different conditions that underlie, different norms that are embodied in and different consequences that attend each.

## II. FUNCTIONAL DIFFERENCES BETWEEN FIDUCIARY AND CONTRACTUAL OBLIGATIONS OF MANAGERS OR CONTROLLERS

The dominant school of contractarians emphasizes maximizing corporate value rather than assuring appropriate distribution of such value between the assertedly contracting parties—i.e. managers or controllers on the one hand and public stockholders on the other.

The classic fiduciary duty of loyalty is considered to be a significant obstacle to that maximizing goal, particularly as it prophylactically precludes transactions that might maximize—or at least make—gains for the enterprise.<sup>73</sup> The classic fiduciary duty is also said to dampen

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<sup>70</sup> For example, the possibility that a buyer of control at a premium will enhance values, which is not so easily asserted for a controller's diversion of values to itself in a freeze-out, is said to justify precluding *a priori* requirements of equal treatment in sales of control. Whether such an incentive is necessary for the seller and whether the cost is worth the benefit are debated questions. See Coffee, *supra* note 62; see also William D. Andrews, *The Stockholder's Right to Equal Opportunity in the Sale of Shares*, 78 HARV. L. REV. 505 (1965); Lucian Arye Bebchuk, *Efficient and Inefficient Sales of Corporate Control*, 109 Q.J. ECON. 957 (1994); Elhauge, *supra* note 63.

<sup>71</sup> Invocation of contract to define restraints on controllers is difficult to justify since there is no express or formal agreement on the matter between controllers and the other holders of common stock; and the basis for implying agreement through operation of the market is too fragile to carry such a heavy burden. Compare Frank A. Easterbrook & Daniel R. Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698 (1982), with Victor Brudney, *Equal Treatment of Shareholders in Corporate Distributions and Reorganizations*, 71 CAL. L. REV. 1072 (1983).

<sup>72</sup> See *Market St. Assoc. v. Frey*, 941 F.2d 588, 595 (7th Cir. 1991); *Kham & Nate's Shoes No. 2, Inc. v. First Bank*, 908 F.2d 1351, 1357 (7th Cir. 1990); Easterbrook & Fischel, *supra* note 2, at 438. Compare Henry N. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians*, 65 WASH. L. REV. 1, 28-29 (discussing the contract doctrine of good faith as a limit on managerial opportunism).

<sup>73</sup> See generally Easterbrook & Fischel, *supra* note 71, at 698.

the incentives of decision-makers by denying them the rewards from self-aggrandizing behavior that they think necessary, in addition to the rewards for which they expressly contract.<sup>74</sup> Hence, the policy aspiration of contractarians is to reduce, if not to eliminate, state-imposed fiduciary restrictions on the power of corporate managers and controllers to engage in conflict of interest transactions or otherwise to serve themselves collaterally at the possible expense of public stockholders.

One doctrinal mechanism for fulfilling that aspiration entails characterizing the fiduciary relationship as simply a contractual relationship, and thus transforming fiduciary obligations to "mere" contract obligations.<sup>75</sup> The suggestion is that state-imposed fiduciary strictures are simply background rules which, like "the law" of contracts, (1) are assumed to have been consented to by the parties and incorporated in their relationship, except where they have agreed otherwise, and (2) are to be interpreted by courts as if they were part of a contract that the parties have deliberately drafted. By imputing a structure that assumes consent of the parties to the presence or absence of state-imposed fiduciary restrictions on management and controllers, the mandatory role of state-prescribed strictures can be muted.

The concept that thus immunizes the parties from "outside" state-imposed mandates and validates their arrangements as freely chosen is the notion of imputed consent. Consent to be bound by (and knowledge of the meaning of) state-imposed rules is imputed to the parties' arrangement to the extent that they do not reject any or all of those rules, which they are presumed to be free to do. Commentators have long noted the ambiguity (if not complete absence) of stockholder consent in these matters.<sup>76</sup> But even if it is appropriate thus to impute

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<sup>74</sup> It is assumed that the efforts of managers and controllers are key to such maximizing, and that only incentives furnished by loosening the constraints of loyalty will induce them to exercise appropriate effort to that end. From that point of view, the law, which cannot *force* managers or controllers to engage in wealth-maximizing behavior for the enterprise, should at least not get in the way by restricting their self-appropriative behavior.

Insofar as the fiduciary mandate embodies the duty of care, it may also be an objectionable example of state intrusion; but it does not impose a heavy obligation because it requires only the minimum acceptable level of performance rather than the maximum possible level.

<sup>75</sup> See Langbein, *supra* note 2, at 665-67; see also *supra* note 2. Common law strictures are treated like public choice theorists treat statutes—as bargains among legislators—and thus as bargains among those favoring and those opposing the strictures.

<sup>76</sup> It is not necessary to resolve the philosophical or sociological problems entailed in ascertaining the meaning of coercion or consent. See, e.g., MICHAEL J. TREBILCOCK, *THE LIMITS OF FREEDOM OF CONTRACT* 58-77 (1993); R. Nozick, *Coercion*, in *PHILOSOPHY, SCIENCE AND METHOD* 440 (Sidney Morgenbesser et al. eds., 1969). It is enough to recognize the difference between the consent that powers classic contract consequences in a one-on-one transaction and the consent imputed to public stockholders (by reason of the action of "independent" directors or

consensual acceptance of (and corresponding broad power to reject) the rules known as "the law" of contracts, it does not follow that importation of fiduciary rules can be as validly imputed so as to make them simply part of a "contractual" arrangement. Nor can assent to deviation from any or all of those rules be as appropriately treated as volitional alteration of an otherwise actually consented to "contractual" arrangement.

### A. *Traditional Fiduciary Loyalty Obligations*

As we have seen, essential to the fiduciary concept is the function of the fiduciary (a function reasonably expected by the beneficiary) to perform services or operate the beneficiary's property for the benefit of the latter. In the case of trusts or principal and agent relationships (and *pro tanto* of corporate management), the fiduciary must act for the beneficiary's exclusive benefit, and, in the case of partnership or corporate controllers for their shared benefit in proportions designated *ex ante*. The fiduciary's entitlement to expressly provided compensation does not open the door to any other mode of reward from dealing with the corporate assets or the stockholders. Correspondingly, the beneficiary is relieved of any concern about specifying or monitoring the fiduciary's appropriative behavior in the course of exercising the broad discretion necessarily delegated.

In contrast, in the classic contract relationship each party acts to benefit himself or herself in carrying out the common enterprise—except as the terms of their arrangement otherwise forbid. Each is expected to act, in the areas of discretion that the contract permits, for his or her own interests and without any regard (in classical contract

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responses to proxy solicitations) to conduct by managers or controllers. Rational apathy precludes dispersed stockholders from acquiring the relevant information that the model contracting party would seek. Rational apathy also deprives their consent to the terms they formally accept of the volitional choice embodied in the consent of the model contracting party and its ability to self-protect. See Anthony T. Kronman, *Contract Law and the State of Nature*, 1 J.L. ECON. & ORG. 5, 11–12 (1985). And if free and knowledgeable consent is not otherwise given by stockholders to exposure to the perils of guileful behavior by managers or controllers, the market hardly operates to supply such consent derivatively. See Brudney, *supra* note 42, at 1420–27; Frankel, *Fiduciary Duties*, *supra* note 3, at 1253–59.

Indeed, to the extent that any consent can be attributed to actual (as distinguished from hypothetical) rational wealth-maximizing stockholders to managerial or controllers' potential opportunism it is reasonable to believe they expect overt compensation of management to be its sole compensation, and shares of stock of a single class to be entitled to equal treatment *vis-a-vis* sharing in corporate assets. So far as "the law" that they can be said to incorporate goes, it is also not unreasonable to believe that they expect it to protect them against management and controllers taking more than they are overtly promised.



doctrine) or with some indeterminate regard (in more modern contract rules) to whether the other is benefited or injured by those acts on his or her own behalf.<sup>77</sup> Consistent with that functional difference, the contract relationship does not require or contemplate that either party will substitute "trust" for "wariness" in the relationship.

To be sure, the contract concept, like the fiduciary concept, requires a limit on the benefits that a party may take for himself or herself from the common enterprise at the other's expense. But the traditional fiduciary concept—whether viewed in terms of exclusive benefit or sharing—would, by definition, forbid or substantially curtail opportunistic behavior by management or controllers that the contract notion permits.<sup>78</sup> Moreover, traditional fiduciary doctrine permits "consent" to departure from those principles only in limited transactions,<sup>79</sup> and

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<sup>77</sup> For a richer discussion of these differences, see Frankel, *Fiduciary Duties*, *supra* note 3. Classical contract doctrine responds to a world in which autonomous human beings are deemed to negotiate with one another volitionally and more or less knowledgeably as adversaries who seek some level of cooperation. They enter into exchange transactions or long term relationships whose terms they are said to have bargained out, and from which each expects to gain, each entertains the possibility of opportunistic behavior and each understands the other to do the same. In that world, each party bears (and expects to bear) the cost of protecting himself or herself against opportunistic behavior by the other—by obtaining information from available sources (including the other), and by insisting upon or yielding protective covenants in exchange for other benefits. To be sure, these conditions do not underlie all contractual relations, and to the extent that the conditions do not obtain, classical contract doctrine has been modified by notions like duress, good faith and unconscionability.

<sup>78</sup> See RESTATEMENT (SECOND) OF TRUSTS § 170 & cmt. w (1959); see also *State ex rel. Hayes Oyster Co. v. Keypoint Oyster Co.*, 391 P.2d 979, 983, 986 (1964).

<sup>79</sup> As a matter of procedure, departure from conventional (i.e. trust and agency) loyalty fiduciary strictures is more appropriately limited to *ex post* consent to a specified transaction than extended to *ex ante* approval of specified types of transactions. See UNIF. TRUSTS ACT §§ 5, 18, 78 U.L.A. 774, 790 (1985). But see CONARD ET AL., *supra* note 37, at 355–57 (setting forth form of blanket *ex ante* consent sought by some practitioners).

The posture of the parties and the bargaining and information disadvantages that underlie fiduciary obligations argue strongly against ever finding that a person, particularly a passive investor, is sufficiently informed and competent, or is acting freely enough, to consider a purported waiver of *all* duty of loyalty to be valid notwithstanding the validity of an appropriately informed waiver or *ex ante* contract foregoing *particular* fiduciary entitlements. See RESTATEMENT (SECOND) OF TRUSTS § 222 (1959) (forbidding exculpation of trustee for intentional breach of trust or waiver of liability prohibition against trustee for profiting from trust); see also RESTATEMENT (SECOND) OF TRUSTS § 170 cmt. W (1959); MODEL BUS. CORP. ACT § 7.32(a) & cmt. 1 (1996); RESTATEMENT OF THE LAW GOVERNING LAWYERS § 202 & cmts. (Tentative Draft No. 4, 1991) (discussing the limits of client consent and the requirements of cognition for consent to be free and valid); SCOTT & FRATCHER, *supra* note 15, §§ 170.1, 222, 222.3; see also 29 U.S.C. § 1110(a) (1994) (prohibiting relief from a fiduciary's responsibilities or liability under ERISA).

The considerations that impel relaxation of limits on consent to the waiver of duty of care under agency and trust law, or among partners or parties in a close corporation, or under recent corporate statutes, do not impel or justify permission for complete waiver of duty of care or for significant waiver of duty of loyalty. See RESTATEMENT (SECOND) OF AGENCY § 379 cmt. a (1959);

in any event it imposes stricter conditions than classic contract norms require for effective consent to modify the arrangements. Thus, disclosure requirements for consent under traditional fiduciary doctrine are more demanding than contract doctrine generally requires.<sup>80</sup> In addi-

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RESTATEMENT (SECOND) OF TRUSTS § 174 cmt. D (1959); see also Branson, *supra* note 45, at 387-94 (1988); DeMott, *Fiduciary Obligation*, *supra* note 3, at 921-23.

Not only is judicial unwillingness to uphold waiver of *all* obligations of loyalty or care likely and appropriate, but there is also judicial insistence on specificity in the terms of the consent or waiver. See *Bassan v. Investment Exch. Corp.*, 524 P.2d 233, 237 (Wash. 1974); see also John C. Coffee, Jr., *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 COLUM. L. REV. 1618, 1664-76 (1989). Compare restrictive rules on waiver in U.P.A. §§ 103(b), 404(b) (1994), 6 U.L.A. § 16, 58 (1995). Practicing lawyers may insert blank check *ex ante* consents to self-dealing by their clients, see, e.g., CONARD, *supra* note 37, but the scope and validity of those consents remains to be determined in concrete cases. See PRINCIPLES OF CORP. GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 5.09 & cmts. (1992); DeMott, *Fiduciary Obligation*, *supra* note 3, at 922; Melvin Aron Eisenberg, *The Limits of Cognition and the Limits of Contract*, 47 STAN. L. REV. 211, 249-51 (1995). If consent can narrow loyalty (i.e. exclusive benefit) obligations in partnership and close corporation contexts, it cannot trump the fiduciary requirement of fairness, which should put a tighter cap on the arrangements than does the "contract" notion of good faith or unconscionability. See *infra* notes 94-101 and accompanying text.

<sup>80</sup> See E. ALLAN FARNSWORTH, FARNSWORTH ON CONTRACTS §§ 4.11, 4.14 (1990); DeMott, *supra* note 37; DeMott, *Fiduciary Obligation*, *supra* note 3, at 906; see also DUGGAN ET AL., CONTRACTUAL NON-DISCLOSURE 51-55 (1994). Compare cases cited *supra* note 29, and RESTATEMENT (SECOND) OF AGENCY §§ 390, 392 (1959), and RESTATEMENT (SECOND) OF TRUSTS § 216, cmt. k (1959), with RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981), and RESTATEMENT (SECOND) OF TORTS §§ 551 (1979), and FOWLER V. HARPER ET AL., THE LAW OF TORTS § 7.13 (2d ed. 1986). But cf. MODEL BUS. CORP. ACT § 8.62(b) (1996).

Courts that deny fiduciary obligations for directors who buy corporate shares from individual stockholders effectively deny contract or tort duty to disclose in that context. See *Percival v. Wright*, 2 Ch. 421, 426 (1902); see also *Goodwin v. Agassiz*, 186 N.E. 659, 660 (Mass. 1933). Courts that affirm fiduciary duties require disclosure. See *Globe Woolen Co. v. Utica Gas & Elec. Co.*, 121 N.E. 378, 379-80 (N.Y. 1918). The Delaware requirement of "complete candor," which was derived from a fiduciary obligation, was thought to reflect a requirement of fuller disclosure than federal securities legislation. See Richard A. Booth, *The Emerging Conflict Between Federal Securities Law and State Corporation Law*, 12 J. CORP. LAW 73, 73-74 (1986). That the Delaware Supreme Court may on occasion have erased that difference does not equate the fiduciary disclosure requirement with any comparable contract law requirement in practice or in theory. Compare *Stroud v. Grace*, 606 A.2d 75, 84 (Del. 1992), with *Zirn v. VLI Corp.*, 621 A.2d 773, 778-79 (Del. 1993), and *Nicolet, Inc. v. Nutt*, 525 A.2d 146, 149 (Del. 1987). But cf. *Kahn v. Lynch Communication Sys., Inc.*, 669 A.2d 79, 88 (Del. 1995); *Arnold v. Society for Sav. Bancorp.*, 650 A.2d 1270, 1276-77 (Del. 1994). See generally Lawrence A. Hamermesh, *Calling Off The Lynch Mob: The Corporate Director's Fiduciary Disclosure Duty*, 49 VAND. L. REV. 1087 (1996). It does not detract from that conclusion that contract doctrine and tort doctrine require disclosure in circumstances involving a confidential and trusting relationship. See RESTATEMENT (SECOND) OF CONTRACTS § 161(d) (1981); RESTATEMENT (SECOND) OF TORTS § 551 (1979); JOHN D. CALAMARI & JOSEPH M. PERILLO, CONTRACTS 369-70 (3d ed. 1987).

Debate over the circumstances in which information should be disclosed to one contracting party by the other, whether rooted in considerations affecting the cost of, and incentive for, discovering it, see, e.g., Anthony T. Kronman, *Mistake, Disclosure, Information, and the Law of Contracts*, 7 J. LEGAL STUD. 1 (1978), or otherwise, see, e.g., MICHAEL J. TREBILCOCK, THE LIMITS OF FREEDOM OF CONTRACT 102-26 (1993), proceeds on the assumption that rational parties are

tion, the volition that drives such consent must be more clearly evident in the traditional fiduciary context than in the classic contract context.<sup>81</sup>

Not only do traditional fiduciary loyalty restrictions thus differ from classic contract rules in content, but fiduciary strictures are not designed like contract background rules to fill gaps in, or enforce, explicitly specified preferences or protective provisions that the parties selected. On the contrary, the fiduciary rules that the State prescribes supply the content of the parties' preferences and protections, not mere "neutral" background rules to implement particular preferences or protections selected by the parties.<sup>82</sup> In contrast to the essentially neutral character of the restrictions on opportunistic behavior imposed by the background rules that are part of contract doctrine,<sup>83</sup> fiduciary rules are historically comprehensive and one-sided. They aim to protect the beneficiary but not the fiduciary against contingencies in areas of conduct in which contracting parties can (and generally do) select adequate protective terms, but beneficiaries and stockholders (even if they are otherwise considered contracting parties) can

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negotiating at arms-length on a more or less equal basis. The notion of the fiduciary as alter ego of the beneficiary rejects that each-for-himself assumption. Moreover, it makes discovered information the "property" of the beneficiary at least as much as of the fiduciary; the cost of acquiring it (and the incentive to do so) is financed by the beneficiary, through the fiduciary's fee or other compensation.

<sup>81</sup> See Frankel, *Fiduciary Duties*, *supra* note 3, at 1235-42; *supra* notes 23-24 and accompanying text.

<sup>82</sup> It is the inability of the stockholder as residual-taker to express, or even to signal, the restrictions on management's or controllers' self-serving behavior in all the various contingencies that may occur during the relationship that gives rise to state-imposed rather than party-prescribed obligations. See *supra* note 41. Fiduciary restrictions cannot be derived from protective terms that restrict management's behavior because the arrangement between the parties generally cannot, and does not, contain adequate terms. In the fiduciary posture, the restrictions are determined at large, rather than interstitially by derivation from the articulated terms of a contract. Possibly the same generalized strictures that traditional fiduciary loyalty obligations entail could be embodied in the language of a contract. Given the same posture of the parties, the reach of that language would create for the parties and the courts interpretive problems comparable to those that arise in defining fiduciary obligations.

The same considerations argue against viewing the fiduciary duty of care as a "mere" contractual obligation. Indeed, its content derives from conceptions of negligence and is no more contractual because the relationship is consensual than is the obligation of a driver to a passenger who simply is along for the ride and does (or does not) consent to narrowing the driver's state-imposed obligations.

<sup>83</sup> For example, the rules prescribing conditions to be met in forming, or requiring good faith in performing, or forbidding unconscionability in the operation of, contracts are designed to set limits on how far *each* contracting party can help himself or herself at the expense of the other. So too are various interpretive rules that address ambiguities or gaps in one-on-one contracts. They operate in light of the protective provisions that the parties have specified to limit the powers that *each* has given to the other.

not.<sup>84</sup> The functional role of management, as actor for the stockholders, and the structural bargaining incapacity and passive posture of the public stockholder which result in the state thus imposing broad fiduciary restrictions, preclude a court from "interpreting" the meaning or scope of these so-called background rules as if they were deliberately and freely adopted by contracting parties.<sup>85</sup>

Indeed, even in the contract ambience, the notion of the parties importing into the contract all or some of the externally imposed background rules—that resolve ambiguities in the terms or enforce the contract—is problematic. It is a strong, and not entirely plausible, suggestion that even relatively knowledgeable parties to contracts understandingly include in their choice of provisions any or all of those background rules.<sup>86</sup> It is even less plausible to convert state-imposed fiduciary strictures into parts of a voluntarily assumed contract. The

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<sup>84</sup> Background rules that prescribe good faith or proscribe unconscionability generally address elaborated preferences expressed in more or less deliberately formulated provisions by parties. The background rules that govern the fiduciary relationship contemplate unarticulated preferences and a significant disparity of information (or potential to acquire it) and volition between the fiduciary and the beneficiary. This is not to deny that the structural position of dispersed parties to many kinds of standard form contracts for consumer goods or services is comparable to that of public stockholders and that the "law" of contracts takes some account of those structural disadvantages through concepts like duress, adhesion, unconscionability and good faith that limit the structurally advantaged parties' power. See FARNSWORTH, *supra* note 80, §§ 4.16–19, 4.26–28 (1990 & Supp. 1996).

<sup>85</sup> Thus to impute to dispersed stockholders the consent to managerial self-serving behavior by a rational wealth-maximizing party to a contract assumes that the stockholder is, like such a party, filling in the interstices of a restrictive arrangement with management or controller that he or she has otherwise constructed. But in fact it is the entire structure of the restrictions that the fiduciary obligation defines. Hence, in resolving a claimed ambiguity in a corporate fiduciary obligation, different considerations are to be consulted than are appropriate in interpreting ambiguities or filling gaps in a contract drafted by the parties. The rational wealth-maximizing party to a relational contract, whose terms have been negotiated by him, deals in an arena which enables him to consider and provide covenants against the risks of his opponent's opportunism. He is subject to different *ex ante* imputations of consent to opportunistic behavior than is the rational wealth-maximizing public stockholder who is not playing in that arena, cannot protect himself by contract, and therefore must put his head into the lion's mouth when he invests. The latter rationally seeks protective reassurances from the state against risks of management's or controllers' opportunism that one in the former's position may rationally believe cost more than they are worth. Even if maximizing joint wealth were the socially appropriate norm for the fiduciary relationship, it does not follow that a mode of filling gaps or ambiguities, which is appropriate for negotiated contracts, will produce the same wealth-maximizing result if invoked to define the boundaries of fiduciary obligations.

<sup>86</sup> The parties do not make, or participate in making, those rules; and their "consent" to incorporating them is derived by imputing to the parties knowledge of the uncertain state of the law and the possibility of its changing in unforeseeable ways over the life of their relationship. That imputation rests upon the alchemy of the market rather than upon any explanation that lawyers or advisors are assumed to offer to the parties or upon knowledge they otherwise normally acquire.

beneficiary's power to waive, or consent *ex ante* to departing from, those strictures in specified circumstances does not enhance that plausibility. Whatever may be said of the power of contracting parties expressly to trump or alter state-imposed contract rules,<sup>87</sup> different considerations color—and limit—the power of a beneficiary to opt out of fiduciary loyalty entitlements.

### B. Corporate Law Fiduciary Loyalty Obligations

Currently imposed corporate fiduciary obligations substantially dilute classic fiduciary restrictions. Indeed, they contemplate that the fiduciary may benefit at the expense of the beneficiary, or at least fail to share all gains from self-dealing, but they offer no theory to justify—or operating guide lines to measure—the limits of opportunistic behavior. Doctrinally, authorization of the power to self-deal may derive either from rejection of the exclusive benefit principle or from the easy imputation of consent by stockholders to departure from the principle by managers or controllers. Statutory prescriptions appear to rely on both.<sup>88</sup> In either case, existence of the power to obtain collateral benefits, as by self-dealing, raises the question of limits on its exercise.

As a matter of positive law, restrictions on self-dealing imposed by courts in fiduciary terms in the corporate context are increasingly slack. But their terms may be somewhat tighter than the restrictions that are imposed under classic contract doctrine or might be imposed under contract doctrine that either requires “good faith” by parties in performing contracts, particularly contracts infected with touches of duress or adhesion, or prohibits results that are unconscionable.<sup>89</sup>

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<sup>87</sup> See Ian Ayers & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87 (1989); DeMott, *Contemporary Challenges*, *supra* note 3, at 484–85; DeMott, *Fiduciary Obligation*, *supra* note 3, at 921–23. Express contract does not trump all fiduciary rule.

<sup>88</sup> See CAL. CORP. CODE § 310(a)(3) (West 1990); DEL. CODE ANN. tit. 8, § 144 (1991); N.Y. BUS. CORP. LAW § 713 (McKinney 1986); MODEL BUS. CORP. ACT §§ 8.61–.63 (1996); MODEL BUS. CORP. ACT § 8.31(a) & cmts. (1986) (section withdrawn 1988).

<sup>89</sup> Evolving corporate fiduciary obligations appear to be narrowing the disclosure requirements imposed on directors seeking stockholder consent to depart from the prohibition against self-dealing, but developing conceptions of adhesion, unconscionability or good faith appear to be expanding disclosure requirements for contracting parties seeking comparable consent. *Compare* *Globe Woolen Co. v. Utica Gas & Elec. Co.*, 121 N.E. 378, 380 (N.Y. 1918), *with* MODEL BUS. CORP. ACT §§ 8.60(4) cmt. 4, 8.62(b) & cmt. 2, *and* *Proctor & Gamble Co. v. Bankers Trust Co.*, 925 F. Supp. 1270, 1290 (S.D. Ohio 1996). See STEVEN J. BURTON AND ERIC G. ANDERSEN, CONTRACTUAL GOOD FAITH: FORMATION, PERFORMANCE, BREACH, ENFORCEMENT 391–414 (1995); PRINCIPLES OF CORP. GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 502(a)(2) (1992); Melvin Aron Eisenberg, *Self-Interested Transactions in Corporate Law*, 13 J. CORP. L. 997, 998 n.5

The congruence, if not overlap, of the restrictions that each might impose on management is suggested by the ubiquity of the concept "fairness" in describing both evolving fiduciary obligations and contract obligations.<sup>90</sup> And the deterrent sanctions that enforce fiduciary obligations,<sup>91</sup> although rarely available for "victims" under classic con-

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(1988); compare *In re Schipper*, 933 F.2d 513, 515-16 (7th Cir. 1991), with *Brass v. American Film Tech., Inc.*, 987 F.2d 142, 150-52 (2d Cir. 1993), and RESTATEMENT (SECOND) OF CONTRACTS § 161 (1981). On the other hand, adumbrations from more recent Delaware decisions suggest more demanding disclosure obligations of fiduciaries. See *Hamermesh*, *supra* note 80; see also *DeMott*, *supra* note 37. But cf. *Kahn v. Lynch Communication. Sys., Inc.*, 669 A.2d 79, 88-89 (Del. 1995).

The volition that is required to power the consent of dispersed stockholders to such departures is becoming hard to find, see, e.g., *Everett v. Phillips*, 43 N.E.2d 18, 20 (N.Y. 1942); see also PRINCIPLES OF CORP. GOVERNANCE: ANALYSIS AND RECOMMENDATIONS §§ 5.02, 5.04, 5.06 (1992), even though it may be more than the evolving contract doctrine requires in the murky areas of undue influence and unconscionability. See FARNSWORTH, *supra* note 80, §§ 4.20, 4.28; Richard Craswell, *Property Rules and Liability Rules in Unconscionability and Related Doctrines*, 60 U. CHI. L. REV. 1 (1993); see also sources cited *infra* note 101.

For analyses that discuss and compare the conditions required for valid stockholder consent to depart from fiduciary strictures with the conditions that meet "good faith" requirements of contract doctrine, see *Coffee*, *supra* note 79, at 1653-64 and John C. Coffee, Jr., *No Exit?: Opting Out, the Contractual Theory of the Corporation, and the Special Care of Remedies*, 53 BROOK. L. REV. 919 (1988). See also *Jordan v. Duff & Phelps, Inc.*, 815 F.2d 429, 438 (7th Cir. 1987); cf. *Market St. Assoc., v. Frey*, 941 F.2d 588, 593-95 (7th Cir. 1991); *Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting*, 908 F.2d 1351, 1356-59 (7th Cir. 1990).

<sup>90</sup> For authorities that reject fiduciary terminology in favor of a requirement of fairness, see MODEL BUS. CORP. ACT §§ 8.30(a), 8.61(b)(3) & cmts. (1996), N.C. GEN. STAT. § 55-8-30 cmt. (1996) and PRINCIPLES OF CORP. GOVERNANCE: ANALYSIS AND RECOMMENDATIONS §§ 5.01, 5.02 (1992). See also *supra* note 36; cf. PRINCIPLES OF CORP. GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 5.09 & cmts. (qualifying limitations). Fairness is also a notion that tinctures the "good faith" that the law of contract requires. See U.C.C. § 2-103(1)(b) (1994); *DeMott, Fiduciary Obligation*, *supra* note 3, at 892-902. Weidner and Larson suggest that the term fairness is more restrictive in the fiduciary context. See *supra* note 36 (discussing Revised Uniform Partnership Act). But cf. Russell M. Robinson, NORTH CAROLINA CORPORATION LAW §14.3, 233-234 (suggesting that eliminating reference to "fiduciary" and substituting "fairness" in corporate law is designed to curtail sanctions against misbehaving directors).

<sup>91</sup> That result dove-tails with the inability of the dispersed public stockholder adequately to provide sanctions by contract. See *supra* notes 15, 82. To be sure, the deterrent sanction in the corporate context is sometimes not as severe as it might be. Compare *Boardman v. Phipps*, 2 App. Cas. 46, 104, 112 (H.L. 1967), and *Greenan v. Ernst*, 184 A.2d 570, 578 (Pa. 1962) (allowing errant corporate fiduciary to be compensated for services rendered), with *Holden v. Construction Mach. Co.*, 202 N.W.2d 348, 356-59 (Iowa 1972), and *American Timber & Trading Co. v. Niedermeyer*, 558 P.2d 1211, 1223 (Or. 1976) (denying even such compensation); cf. *Snapp v. United States*, 444 U.S. 507, 515-516 (1980). However, recent cases occasionally suggest that for directors, or controlling stockholders in contexts that would invoke sharing principles, rescissory damages that may well be punitive are appropriate. See *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 371-72 (Del. 1993) (*Cede & Co. I*); *In re Tri-Star Pictures, Inc.*, 634 A.2d 319, 333 (Del. 1993); *Weinberger v. UOP, Inc.*, 457 A.2d 701, 714 (Del. 1983). But cf. *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1134, 1140-47 (Del. Ch. 1994), *aff'd*, 663 A.2d 1156 (1995). See also *Coggins v. New England Patriots Football Club, Inc.*, 492 N.E.2d 1112, 1119-20 (Mass. 1986); *Booth*, *supra* note 80, at 100-83. In any event, the uneven application of deterrent sanctions in corporate law

tract doctrine,<sup>92</sup> may occasionally be matched by the sanctions imposed under contract doctrines like good faith or unconscionability.<sup>93</sup>

Notwithstanding the movement of positive law, if the limits on self-aggrandizing conduct are to be faithful to their proclaimed origins in fiduciary premises, they should be more restrictive than limits derived from contract premises—even those premises underlying the more flexible contract doctrines that protect structurally dependent (often dispersed) parties disadvantaged by bargaining power and information disparities. Analytically, the function of the fiduciary requires courts to approach gray areas in the interpretive process with a sense that the center of gravity of the fiduciary obligation is in the beneficiary's interests. In contrast, the center of gravity of the obligation of an arm's-length contracting party is in its own, rather than the other party's, interests. Even if contract doctrines—such as good faith or unconscionability—locate the center somewhere in between, neither contract theory nor contract doctrine requires one party to focus solely on the interests of the other or permits the courts to interpret the contract through a lens with such a focus.

Diluted corporate fiduciary obligations start from the exclusive benefit principle, and the question is how far from that starting point the fiduciary may be permitted to go in appropriating benefits for itself. Claims of bad faith or unconscionability start from the premise that the party charged was entitled to seek all the advantage the contract might permit, and the question is how to limit the benefits he

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hardly reduces the deterrent role of disgorgement and rescissory damages to their non-role as sanctions for violation of contracts generally. See Farnsworth, *supra* note 17, at 1354. Nor does the fact that disgorgement and rescissory deterrent remedies are occasionally allowed, see GEORGE E. PALMER, *LAW OF RESTITUTION* § 2.12 (1978), in contract or tort cases that involve especially "egregious" misbehavior or conditions comparable to those involved in the classic fiduciary context diminish the significance of those remedies as a functional attribute of the fiduciary relationship. See *id.* § 2.11 (1978 & Supp. 1996); see also *Stone v. Martin*, 355 S.E.2d 255, 259-60 (N.C. 1987). Such episodic references do not assimilate "mere" contract or tort to the fiduciary relationship. See, e.g., W. PAGE KEETON ET AL., *PROSSER AND KEETON ON THE LAW OF TORTS* §§ 94, 105 (5th ed. 1984) (suggesting those remedies are not always available and, in any event, are limited in scope); DeMott, *Fiduciary Obligation*, *supra* note 3, at 888; Jackman, *supra* note 21.

<sup>92</sup> See, e.g., FARNSWORTH, *supra* note 80, §§ 12.3, 12.8 (2d ed. 1990); George M. Cohen, *The Fault Line in Contract Damages*, 80 VA. L. REV. 1225 (1994). Contract damages are not always confined to payment that is only compensatory, see, e.g., Gergen, *supra* note 28, at 1072-75; Scallen, *supra* note 3, at 912-13, but that general theme is central to the notion of damages in contract. See, e.g., Farnsworth, *supra* note 17, at 1356.

<sup>93</sup> Victims of "bad faith," unconscionable behavior or duress occasionally receive the benefit of deterrent sanctions. See, e.g., Alan O. Sykes, "Bad Faith" Breach of Contract by First-Party Insurers, 25 J. LEGAL STUD. 405, 409, 414, 428 (1996); see also, Andrew Kull, *Restitution as a Remedy for Breach of Contract*, 67 S. CAL. L. REV. 1465 (1994) (discussing the remedy of rescission in limited circumstances).

or she may appropriate at the expense of the other party. The concept of "fairness" should not carry the same substantive import in the fiduciary context that it may in the contract context. "Fairness" in corporate law fiduciary terms is said to embody limits on the consensual<sup>94</sup> allocation of gains to management or controllers from self-aggrandizing conduct by reference to arm's-length bargains or "the market"<sup>95</sup>—a restriction that is said to limit managers' or controllers' gains more rigorously than does the freedom of the parties to deal under contract rules, particularly classic contract rules.<sup>96</sup> It is not self-evident that the market or the hypothetical arm's-length bargain is a sufficiently restrictive standard of fairness for a fiduciary.<sup>97</sup>

To depart from the exclusive benefit rule as has corporate law, and substitute a "fairness" test, does not require shifting the fiduciary relationship to the arm's-length relationship contemplated by the market for an exchange transaction. On the contrary, although the depar-

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<sup>94</sup> If the self-dealing transaction is "consented to" by stockholders—by vote of either independent directors or dispersed stockholders—the ephemeral quality of the consent invites a state-imposed cap on the substance of the transaction, even if the matter is viewed as one of contract.

<sup>95</sup> Instead of the exclusive benefit principle which would deny any and all gain to managers or controllers, fairness permits them to share in the gain; but it restricts the sharing by reference to how the market or some comparable arms-length standard would divide the gain between the transacting parties. See *International Radio Tel. Co. v. Atlantic Communications Co.*, 290 F. 698, 702 (2d Cir. 1923); *Ewen v. Peoria & Eastern Ry. Co.*, 78 F. Supp. 312, 316-17 (S.D.N.Y. 1948); *Cookies Food Prod., Inc. v. Lakes Warehouses Distrib., Inc.*, 430 N.W.2d 447, 453-54 (Iowa 1988); MODEL BUS. CORP. ACT. § 8.31 cmt. 4 (1986) (section withdrawn 1988); Clark, *supra* note 21, at 73-75; Note, *The Fairness Test of Corporate Contracts with Interested Directors*, 61 HARV. L. REV. 335 (1948). But cf. Easterbrook & Fischel, *supra* note 71.

<sup>96</sup> See Clark, *supra* note 21, at 74-75.

<sup>97</sup> See ROBERT CHARLES CLARK, CORPORATE LAW § 5.4.2 (1986). Fairness so-defined leaves the fiduciary with incentives to self-aggrandize because the number of unpoliceable (and unlitigated) transactions (resulting from the beneficiaries' rational apathy, if nothing else) assures that a market price rule will result in transactions that are rarely if ever at prices less favorable to the fiduciary than market, and on average at more favorable prices. Something more than what the market price would give the beneficiary is the requirement of fairness for one who places his economic interests in the hands of another to manage for him, and like public stockholders is in the structurally disadvantageous position to control or monitor a management exposed to strong temptation to overreach. Cf. *Mosser v. Darrow*, 341 U.S. 267 (1950). Indeed, if the market price is more favorable to the beneficiary than the fiduciary's cost, there is good reason to hold the latter to the market price that the beneficiary could get if not hobbled by the fiduciary. See, e.g., Security Exchange Act Release No. 26,198 (Oct. 19, 1988) (dealing with parent-subsidiary transactions). In contrast, nothing better need be required for a victim whose entitlement is defined by contract in a relationship that contemplates indeterminate gain for each of the parties at the possible expense of the other on the assumptions of a market transaction. The contract notion of good faith is designed, at most, to rectify the disadvantage of a person who is innocently (or at least not culpably) exposed to opportunistic behavior in a relationship entered into on the premises of free and equal exchange in a market transaction. Hence, arguably he or she is entitled to no better than he or she would have gotten in such an exchange. See SEA Release, *supra*.



ture may contemplate the possibility of *some* gain for the fiduciary, the weakness of the stockholders' consent argues for a deterrent sanction that the market standard simply cannot supply. The information asymmetry and uneven bargaining relationship between the parties coupled with the "trust" that colors their dealings require the fiduciary to end up with less gain than the market might give, and the beneficiary to receive a better "deal" than a stranger might give.<sup>98</sup> Delineating the limits of that "deal" is difficult. But that does not justify the otherwise questionable use of the contract-derived market test simply because "the market is there."

In any event, in the cases likely to present challenges, a market is generally not available to measure fairness. Instead, fairness is sought as the product of a bargain that the parties would have struck if they were dealing at arm's length. It may be achieved anywhere within a range, generally a wide range, of possible results<sup>99</sup>—determined by the opinions of experts hired by the parties, who generally rely on the terms of actual transactions that they deem comparable to the transaction at hand. The fiduciary relationship, even as diluted for corporate managers or controllers, suggests a location of fairness within that range that is considerably less favorable to management or controllers than do contract premises,<sup>100</sup> including good faith requirements.<sup>101</sup> The

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<sup>98</sup> See Cooter & Freedman, *supra* note 15; Mitchell, *supra* note 3.

<sup>99</sup> See MODEL BUS. CORP. ACT § 8.61(b)(3) & cmt. 2 (1996).

<sup>100</sup> Management or controllers' temptation to self-aggrandize and the difficulty of detecting or selectively prohibiting it call for restrictions on such behavior—whether because of fiduciary or contractual obligations. However, the considerations that generate fiduciary restraints (i.e. the fiduciary's role as alter ego) call for the determination of fairness to the beneficiary in self-dealing transactions by managers to be at or beyond the end of that range of prices that is most favorable to the beneficiary. If the beneficiary is selling, the test of fairness should be at or beyond the upper end of the range; if the beneficiary is buying, it should be at or beyond the lower end. This substantive test of fairness for a fiduciary may appropriately contrast with *any* substantive test of "good faith" or other standard in contract doctrine. To the extent that notions of unconscionability or lack of "good faith" inform contract doctrine (which contemplates an arm's-length adversarial relationship between the parties), for example, they point to limiting the behavior of the person charged by reference to the other end of the fairness range. Culpability would be demonstrated by behavior that leaves the complainant worse off than he would be at the end of the range of fair behavior that is least favorable to the him. See, e.g., *Williams v. Walker Thomas Furniture Co.*, 350 F.2d 445, 449–50 (D.C. Cir. 1965).

Positive law, at least in Delaware, may impose a lesser burden of proof of fairness upon management or a controller than upon a trustee. See SCOTT & FRATCHER, *supra* note 15, § 496; cf. *Michelson v. Dunan*, 407 A.2d 211, 217 (Del. 1979); *In re Wheelabrator Techn. Shareholders Litigation*, 663 A.2d 1194 (Del. Ch. 1995). Although the weight of that burden is not easily measured, it does not leave management quite as burdened as a plaintiff in a suit on an arm's-length contract.

<sup>101</sup> See, e.g., RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981); U.C.C. §§ 1–203, 2–306(1) (1994). "Good faith," may be narrowly understood to stretch the interpretive process no further

fiduciary concept of "fairness" thus invoked implies, and appears in many cases (even if not in all) to produce, tighter restraints on management's and controllers' conduct than contract doctrine would require.<sup>102</sup> It has similarly more restrictive implications for controllers' conduct, particularly in control transactions.

The only restrictions on self-dealing in corporate law that are systematically colored more by the contract notion than by the diluted fiduciary concept appear in the limits on management's express compensation. To measure the limits of management's substantively, if not formally,<sup>103</sup> self-appropriated compensation by reference to "waste"<sup>104</sup>

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than is permitted if the focus is on the autonomy of contracting parties and the explicit choices embodied in their contract. Or it may be read more broadly as an instrument of social policy that, however, is limited by the need to take account of the claim that the players are autonomous parties who have made explicit choices. Compare Steven J. Burton, *Good Faith in Articles 1 and 2 of the U.C.C.: The Practice View*, 35 WM. & MARY L. REV. 1533, 1558-60 (1994), with Richard E. Speidel, *Article 2 and Relational Sales Contracts*, 26 LOY. L.A. L. REV. 789, 795-98 (1993). However narrowly or broadly "good faith" may be interpreted in the commercial contract context, it entails the notion of limits that derive from terms that actual adversaries in a real society more or less consciously seek to impose on, or are willing to concede to, one another. Thus whether the problem is interpreting the scope of an authorization in the text of a contract or a related legal stricture, or simply of the discretion intended by the parties or left by a gap, "good faith" requires one party to "consider" the other party's interest in exercising discretion under their contract and thus seeks limits on the extent to which the party may serve his own interests. But it does not seek (as does the classic fiduciary stricture) to prevent him or her from serving those interests, whether or not at the risk of some harm to the other party. Hence, while it thus imposes limits on opportunistic behavior, see Mark P. Gergen, *A Defense of Judicial Reconstruction of Contracts*, 71 IND. L.J. 45, 77-80 (1995), it is apparently not as confining as a "best efforts" requirement, see Gergen, *supra* note 28, at 1066, and, at least formally, it is less confining than even current corporate fiduciary doctrine. Cf. authorities cited *supra* note 14; FARNSWORTH, *supra* note 80, § 7:17A at 330; John C. Coffee, Jr., *supra* note 79 at 1653, 1658. Compare Steven J. Burton, *Breach of Contract and the Common Law Duty to Perform in Good Faith*, 94 HARV. L. REV. 369, 394-95 & n.109 (1980), with Dennis M. Patterson, *Good Faith, Lender Liability, and Discretionary Acceleration: Of Llewellyn, Wittgenstein, and the Uniform Commercial Code*, 68 TEX. L. REV. 169 (1989), and Robert S. Summers, *The General Duty of Good Faith: Its Recognition and Conceptualization*, 67 CORNELL L. REV. 810 (1982). See generally BURTON & ANDERSEN, *CONTRACTUAL GOOD FAITH* (1995); DeMott, *Fiduciary Obligation*, *supra* note 3, at 892-902; Saul Levmore, *Variety and Uniformity in the Treatment of the Good-Faith Purchaser*, 43 J. LEGAL STUD. 43 (1987).

<sup>102</sup>In some kinds of cases, principally management buy-outs and defenses against take-overs or controllers' absorption of subsidiaries or going private transactions (for which it is hard to decipher any restraint imposed by "mere" contract), the cases often invoke the fiduciary construct and, at least formally, seek to test the propriety of the transaction by its "fairness." See, e.g., *Edelman v. Fruehauf Corp.*, 798 F.2d 882, 885-86 (6th Cir. 1986); *Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A.2d 34, 42 (Del. 1994); *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140, 1150-51 (Del. 1989); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954-57 (Del. 1985). But cf. *Unitrin, Inc. v. American Gen. Corp.*, 651 A.2d 1361, 1389-90 (Del. 1995). For restraints on controllers that require some (possibly proportionate) sharing, particularly in control transactions, see *supra* notes 62 and 64.

<sup>103</sup>See *supra* note 46.

<sup>104</sup>Compare the predominance of reliance upon the concept "waste," see, e.g., *Cohen v. Ayers*, 596 F.2d 733, 739, 740 (7th Cir. 1979); *Grimes v. Donald*, 673 A.2d 1207, 1219 (Del. 1996);

suggests analogy to the contract notion of "unconscionability." Judicial review of the board's decision in terms of "business judgment"<sup>105</sup> further supports the idea of the discretion available to parties in a "mere" contractual relationship. While the phenomenon can be explained,<sup>106</sup> it is hard to see how it can be justified.<sup>107</sup>

In sum, traditional fiduciary loyalty strictures more rigorously protect common stockholders against opportunistic behavior by managers or controllers than does classic contract doctrine. Even the diluted corporate law fiduciary obligations should—and often do—offer more protection than does classic contract doctrine.

### C. *The Wealth-Maximizing Norm And The Fiduciary Relationship*

The effort to assimilate the fiduciary relationship to "contract" generates questions with respect to the relevant contract concept to be tapped to solve problems of delineating restraints on management's

Michelson v. Duncan, 407 A.2d 211, 217 (Del. 1979); Marx v. Akers, 666 N.E.2d 1034 (N.Y. 1996); R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, *THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS* §§ 4-276, 4-277 (Supp. 1997); PRINCIPLES OF CORP. GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 5.03(a)(2)(c) (1992); Paul K. Rowe, *Defending Executive Compensation in the Courts: Substance and Strategy*, 6 INSIGHTS No. 4, at 12 (Apr. 1992); cf. Byrne v. Lord, Fed. Sec. L. Rep. (CCH) ¶ 98,987 (Del. Ch. 1995); Heineman v. Datapoint Corp., No. CIV.A.7956, 1990 WL 154149, at \*2 (Del. Ch. Oct. 9, 1990), and the occasional references to the requirement of "no relation to the value of the services rendered." See Rogers v. Hill, 289 U.S. 582, 591-92 (1933); see also Fogelson v. American Woolen Co., 170 F.2d 660, 663 (2d Cir. 1948); cf. Investment Company Act §36(b), 15 U.S.C. § 36 (1994), interpreted in Krinsk v. Fund Asset Management, Inc., 875 F.2d 404, 409-10 (2d Cir. 1989); Gartenberg v. Merrill Lynch Asset Management, Inc., 694 F.2d 923, 928-32 (2d Cir. 1982).

<sup>105</sup> The carte blanche given to "disinterested" directorial judgement that the compensation (1) will produce future services and (2) will be reasonably worth the cost is only occasionally withheld, but that withholding is almost never followed by judicial determination that the compensation is in fact excessive. See, e.g., Cohen v. Ayers, 596 F.2d 733, 739-41 (7th Cir. 1979); Beard v. Elster, 160 A.2d 731, 737-39 (Del. 1960); Byrne, Fed. Sec. L. Rep. (CCH) at ¶ 98,987.

<sup>106</sup> One possible explanation for contract-based limits on management's overt compensation is that, structurally, neither the exclusive benefit principle nor its prophylactic implementation can be invoked in that circumstance. Also, such transactions are formally framed in contractual terms, in contrast to most self-dealing or other self-appropriative transactions. More plausibly, employment compensation rests on factors peculiar to each management and corporation. Therefore, unlike self-dealing or other modes of self-aggrandizing, it does not yield to generalized strictures except of the vaguest kind. The intractability of the incentive and the quantifying problems in determining "excessive" compensation often seems to drive courts to the contract stance (and the "waste" standard) in order to diminish the need to confront that intractability. See, e.g., Heller v. Boylan, 29 N.Y.S.2d 653, 679-80 (N.Y. Sup. Ct.), *aff'd*, 32 N.Y.S.2d 131 (N.Y. App. Div. 1941); see also Carl T. Bogus, *Excessive Executive Compensation and the Failure of Corporate Democracy*, 41 BUFF. L. REV. 1 (1993); Douglas C. Michael, *The Corporate Officer's Independent Duty as a Tonic for the Anemic Law of Executive Compensation*, 17 J. CORP. LAW 786 (1992); Detlev Vagts, *Challenges to Executive Compensation: For the Markets or the Courts?*, 8 J. CORP. LAW 231 (1983); Geoffrey S. Rehnert, Note, *The Executive Compensation Contract: Creating Incentives to Reduce Agency Costs*, 37 STAN. L. REV. 1147 (1985).

<sup>107</sup> The problem of quantifying the limits of "fairness" is not easier than that of quantifying

or controlling stockholders' self-serving behavior. There is more than one vision of "contract,"<sup>108</sup> and contract doctrine offers more than one approach to such problems.

The suggestion that state-imposed fiduciary strictures are simply terms of a contract to which the parties have consented and which they may freely alter is the predicate for the contractarians' special method of interpreting ambiguities or gaps in the "contract," including the fiduciary background rules that the parties are assumed to have adopted.<sup>109</sup> Gaps or ambiguities with respect to a particular contingency that cannot be resolved from the terms should be resolved by asking what hypothetical, rational, wealth-maximizing parties would have provided to be done in the contingency under scrutiny if they had thought of the problem when they entered into the relationship.<sup>110</sup> The answer given rests in large part on the premise that such hypothetical actors would believe that the added incentives offered by personal gain from self-aggrandizing use of corporate assets would stimulate managers or controllers to create gain for all—i.e., to increase the value of the enterprise.<sup>111</sup> Therefore, restrictions on fiduciaries in such transactions should be deemed waived by beneficiaries (or effectively eroded) in the interest of a systemic expectation of net gain.

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the limits of "non-waste." But the former standard suggests narrower and more appropriate limits than the latter.

<sup>108</sup> See, e.g., PATRICK ATIYAH, *ESSAYS ON CONTRACT* (1990); TREBILCOCK, *supra* note 76; Arthur Allen Leff, *Contract as Thing*, 19 AM. U. L. REV. 131 (1970). Quite apart from communitarian assumptions, see generally Peter Linzer, *Uncontracts: Context, Contorts and the Relational Approach*, ANN. SURV. AM. L. 139 (1988), there are variations in the autonomy-based norms resting on libertarian or utilitarian assumptions. Compare EASTERBROOK & FISCHEL, *supra* note 66, chs. 4, 5, and Easterbrook & Fischel, *supra* note 71, at 702, with CHARLES FRIED, *CONTRACT AS PROMISE*, 7-18, and Randy E. Barnett, *A Consent Theory of Contract*, 86 COLUM. L. REV. 269 (1986), and Randy E. Barnett, *The Sound of Silence: Default Rules and Contractual Consent*, 78 VA. L. REV. 821 (1992), and Butler & Ribstein, *supra* note 2, at 17, 28-30.

<sup>109</sup> The beneficiary is presumed to be as able to freely consent to value-increasing, self-dealing transactions as is a party to a contract to agree to circumvent mutable restrictions imposed by "the law" of contracts.

<sup>110</sup> See generally Easterbrook & Fischel, *supra* note 2; Easterbrook & Fischel, *supra* note 71, at 703-04; Langbein, *supra* note 2. The assumption is that the parties would have provided an identifiable solution to the ambiguity or gap. Of course, the further assumption is that in the absence of ambiguity or gap the rational wealth-maximizing party must yield to the terms of the contract, which by definition contain neither ambiguity nor gap.

<sup>111</sup> Rational wealth-maximizing stockholders should be willing *ex ante* to enter into arrangements that allow appropriative behavior by managers or controllers that, on average, is expected to induce efforts to enhance the collective value for all. Certainly such shareholders should be willing to do so if it does not deprive them of *some* of the expected gains to the self-dealers from the efforts; they should rationally be willing to do so even if *ex post* they receive no part of those gains, but share in the expanded value of the enterprise. And, in theory, they should be willing to enter into such arrangements *ex ante* even if they may, in the end, be deprived of some of

Notwithstanding the contractarians' ideological premise that favors fulfilling individuals' freely made choice, their interpretive methodology rejects that premise. Whether the framework of analysis is characterized as "fiduciary" or as "contract," resort to hypothetical bargainers to resolve ambiguities scants choice by individual actors. It drives the decision not by the moral force of actual individuals' consent inferred in the particular case, but by the dictates of the contractarians' general conception of efficiency in the run of cases.<sup>112</sup>

The proffered joint wealth-maximizing justification does not necessarily implicate maximizing the wealth of each party. On the contrary, both in theory and in practice, it entails the distinct possibility of reducing the wealth of some of the parties while augmenting the wealth of others.<sup>113</sup> Moreover, if this justification does not actually contemplate totally depriving the stockholders of any share in the insiders' gain or indeed inflicting loss upon them, it leaves open-ended the questions of whether or how to share any enhancement of joint

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their putative share of the expected enhanced enterprise values. In sum, public investors in common stock should rationally accept the possibility of distributions to them from the bottom half of the dispersion of expected returns even though the top would be skimmed by controllers for themselves—presumably because that arrangement would increase the mean expected return. See EASTERBROOK AND FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW*, 110–26 (1991). The practices of venture capitalists in demanding senior participations along with equity suggest reason to doubt the acceptability, let alone the rationality, of such open ended risk-return allocations. At the very least, consent to indeterminate departure from equality of treatment of public stockholders can only be considered informed and volitional if it rests on express disclosure. For debate on the question of the need for and propriety of unequal distribution, compare Victor Brudney and Marvin A. Chirelstein, *Fair Shares in Corporate Mergers and Takeovers*, 88 HARV. L. REV. 297 (1974) and Brudney, *supra* note 71 with Easterbrook & Fischel, *supra* note 71 and EASTERBROOK & FISCHEL, *supra* note 66. Compare Robert W. Hamilton, *Private Sale of Control Transactions: Where We Stand Today*, 36 CASE W. RES. L. REV. 248 (1985), with Elhauge, *supra* note 63.

<sup>112</sup> See, e.g., David Charny, *Hypothetical Bargains: The Normative Structure of Contract Interpretation*, 89 MICH. L. REV. 1815, 1823 (1991); Daniel P. Brudney, *Hypothetical Consent and Moral Force*, 10 LAW & PHIL. 235 (1991). The hypothetical actor is simply a fictitious implementer of the contractarians' conception of an efficient solution. The only choice that fully informed idealized wealth-maximizing actors will make is the choice that efficiency requires, presumably calculated by netting the probable costs and benefits of possible alternatives and "choosing" the most beneficial solution.

<sup>113</sup> The "incentive" justification for open-ended self appropriative compensation rests upon the premise that on average it will stimulate executives and controllers to cause greater returns for stockholders. But "on average" implies that in many cases self appropriative behavior will exceed collective gain. Moreover, even if such appropriative behavior were required to leave public investors with some share of gain from enhanced value of collective assets, the price that they would rationally charge for their capital would be larger (possibly wastefully larger) than if management's and controllers' rewards were limited to those explicitly and overtly described. See *supra* note 54. In any event, if "gain" to public stockholders is measured by reference to a benchmark that managers or controllers (rather than the neutral "market") fix, as when gain is measured by stock prices that can be, and often are, manipulated in anticipation of control

wealth and insiders' gains. That open-endedness has implications for the "efficiency" that the norm is claimed to produce.<sup>114</sup> However appropriate a joint wealth-maximizing aspiration and its associated risks may be in a world of bargains between more or less equal and informed contracting parties, it is not easily justified in the conditions that determine the fiduciary relationship between dispersed stockholders and management or controllers.

No less important, this justification rests on value or policy preferences<sup>115</sup> that are subject to substantial debate in the context of the relationship between management or controllers and dispersed public stockholders. Traditional fiduciary loyalty restrictions emphasize preventing appropriation of the beneficiary's assets by her "alter ego." Maximizing the value of those assets may (or may not) require prohibiting such appropriation. But the need to prevent or discourage the appropriation undoubtedly qualifies the maximizing aspiration and removes it from the center of the fiduciary focus. If the preferability of the traditional fiduciary notion is to be measured in conventional cost-benefit terms, considerable empirical inquiry is needed before its historic role is rejected in the corporate context.

If values not touched by such cost-benefit analyses are to be considered, the case for rejection of that historical role is not made stronger.<sup>116</sup> Indeed, the explosive increases in rewards to management during

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transactions, there is the question whether any real gain is realized by stockholders from the self-dealing transactions.

<sup>114</sup> Doubt about the actuality of the parties' consent, *see supra* notes 76, 112, leaves uncertainty about what preferences are being vindicated to produce the theoretically optimal result. There are theoretical problems in the way of achieving optimality if bilateral bargaining is the process to which the parties are deemed to be remitted. There are also troublesome interpretive questions about the operation of the norm of the hypothetical investor (e.g., how could that investor "clarify" ambiguity in one clause of an integrated complex agreement without altering others? *Cf.* Trebilcock and Dewees, *infra* note 154, at 416) and questions about judicial institutional competence to determine efficiency. Other obstacles to achieving efficiency (such as second-order costs) are generated by permitting indeterminate self-aggrandizing transactions by managers or controllers. *See supra* note 54.

<sup>115</sup> Derision of the notion that "ethics rather than economics best explains the legal rules," *see, e.g.*, EASTERBROOK & FISCHEL, *supra* note 2, at 428 n.6, seems to assume that the normative preference for efficiency (derived "rigorously" from assumptions about the human condition and human values) is not itself an ethic (embedded in its assumptions) to which other "ethics" may not (or may) be preferable. *Cf.* TREBILCOCK, *supra* note 80. In any event, the question remains whether the asserted irrelevance of ethics is a function of the demands of efficiency rather than of the strength of political power.

<sup>116</sup> *See supra* note 21 and accompanying text; *see also* William W. Bratton, *Game Theory and the Restoration of Honor to Corporate Law's Duty of Loyalty*, in *PROGRESSIVE CORPORATE LAW* 139 (Lawrence E. Mitchell ed. 1995); William W. Bratton, *Public Values and Corporate Fiduciary Law*, 44 *RUTGERS L. REV.* 75 (1992); Chapman, *supra* note 11. Other relevant values that are scanted by contractarians involve possible consequences of social discontent or dilution of moral aspira-

the past several years—a phenomenon that has attracted more than casual discontent in the press—have occurred in connection with management's express compensation.<sup>117</sup> In that matter, as we have seen, legal doctrine limiting self-aggrandizing behavior is closest to the contract model and furthest from the fiduciary model. The contract model's relatively low barrier to managerial self-rewards may not be the only reason for the immense increases in managements' express compensation. But a higher barrier would surely have reduced the magnitude of those increases whose value to the firm and to society is not self-evident. Whether such returns to management are necessary (or indeed relevant) to increasing returns per unit of risk or stock prices to stockholders remain questions to be examined.

Some contract doctrine may implicate restrictions on managers or controllers comparable to those created by the diluted fiduciary doctrine restricting management's and controllers' self-aggrandizing conduct.<sup>118</sup> Other contract doctrine is less restrictive than even the least restrictive corporate fiduciary notions that have yet been accepted. To urge that contract rather than fiduciary doctrine does (or should) govern, or that the latter is merely a sub-species of the former, produces little illumination unless the relevant contours and policy implications of each are identified. In any event, if "mere" contract theory should determine the restrictions on management and controllers, the

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tions resulting from public perception of gaudy returns to controllers and management, particularly at times when much of society may be subject to contraction in welfare and opportunities.

<sup>117</sup> E.g., in the form of stock options whose strike prices can be reset downward, and apparently frequently are, if the price of the stock under option goes down and whose upward possibilities of return are subject to factors unrelated to management's contribution to the enterprise. The theory appears to be that what goes up is attributable to the talent and energy of management, but that what goes down is unrelated to any lack of managerial talent or energy. That such options also create other conflicts of interest about dividend policy and other matters between management and stockholders has been suggested. See Yermack, *supra* note 46; Christine M. Jolls, *Unraveling the Puzzle of Stock Repurchases: The Role of Incentive Compensation in Buyback Decisions* (unpublished manuscript, on file with *Boston College Law Review*).

<sup>118</sup> As the courts and legislatures erode features of traditional fiduciary doctrine that protect dispersed stockholders and augment comparable features of developing contract doctrine (like good faith or unconscionability) the lines may converge, or even cross. Contractarians who equate corporate fiduciary obligations with "mere" contract obligations do not predicate their equation on such developments. Rather, the vision of contract to which they would assimilate corporate management's (or controllers') obligations to the public stockholders is the classic notion of the bargain between two autonomous persons of roughly equal bargaining power and access to information. Their obligations *inter se* are envisioned as considerably narrower than those imposed by expanding conceptions of duress, adhesion, unconscionability and good faith in contract doctrine. See, e.g., *Industrial Representatives, Inc. v. CP Clare Corp.*, 74 F.3d 128, 132 (7th Cir. 1996) ("Contract law does not require parties to be fair, or kind, or reasonable, or to share gains or losses equitably").

fiduciary rhetoric should be abandoned, and investors should be so informed.<sup>119</sup> The presence or absence of protections provided for public common stockholders by contract doctrine should be articulated, and the extent of the asset diversion permitted by contract doctrine should be explained.<sup>120</sup>

### III. OBLIGATIONS TO SENIOR SECURITY HOLDERS

#### A. *The Incongruity of Fiduciary Obligations*

Public investors in bonds and preferred stock are not much—if any—more informed or volitional in accepting the terms of their contracts than are investors in common stock. Nor are they less subject to self-aggrandizing behavior by management or controllers than are public shareholders of common stock (“commons” or “common stock”), or immune from such behavior by the holders of common stock as a class.<sup>121</sup> The question arises whether such senior investors are in a position comparable to beneficiaries so as to require the protection of fiduciary obligations, even as diluted as these obligations are in protecting public common stockholders. The answer rests essentially on two propositions. First, although management is not technically an agent, functionally it is usually the representative of the common stock interest rather than of senior securities’ (“seniors”) interests in con-

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<sup>119</sup> Some authorities would candidly alter the fiduciary terminology and further loosen the threads woven by historic fiduciary obligations. See *supra* note 90; Alex Elson & Michael L. Shakeman, *The ALI Principles of Corporate Governance: A Tainted Process and a Flawed Product*, 49 BUS. LAW. 1761, 1770–78 (1994).

<sup>120</sup> For example, does the contractarians’ model contemplate appropriation of gain or diversion of assets by controllers or management in any and every transaction that is not more or less expressly forbidden? Are the limits on such permitted appropriation or diversion determined by the imputed preferences of the hypothetical wealth-maximizing rational investor if, *ex ante*, he could have foreseen the appropriative or diverting conduct? If the contractarians’ model contemplates other criteria for setting limits on such conduct, how do they operate?

If, as is occasionally suggested, many public investors understand the answers to these questions, there is little cost in requiring plainer explanations to them. If some public investors do not so understand, explanation would further both efficiency and equity—presumably at some cost but not necessarily at a net cost. See NORMAN S. BUCHANAN, *THE ECONOMICS OF CORPORATE ENTERPRISE* 452–59 (1940).

<sup>121</sup> The need for senior security holders to restrict management and common stockholders in exercising powers over the firm and its assets that may be permitted by contract or law arises in several contexts—possible insufficient attention to or incompetence in the task of making sufficient returns for the seniors; taking risks beneficial to juniors but injurious to seniors with a greater likelihood and extent than the seniors expected or could reasonably expect for the returns promised; diluting the seniors’ claims by borrowing additional amounts; coercing dilution of the restrictions on common stock. All of these possibilities exist if the seniors have not guarded against such behavior by protective covenants or if fiduciary strictures are not invocable.



ducting corporate affairs. Second, the seniors' relationship with commons does not contemplate (and cannot contemplate unless expressly provided) that the latter should have an agent's role for the former, or even a self-denying role, in the creation of the wealth of the enterprise and the division of its returns. Both propositions are disputed.<sup>122</sup> We will return to the first proposition after examining the reason and import of the second.

### 1. Obligations of Common Stockholders to Senior Security Holders

The senior security holders contribute to the enterprise in order to obtain a limited, albeit prior, return from the use of their contribution by the commons through the efforts of the management that in theory the commons indirectly select. But the commons are not engaged in a limitedly compensated effort on behalf of the senior investor. They are not acting solely, or indeed principally, for the benefit of the seniors. Nor is the common stock subject—except as specified in the investment contract—to the seniors' direction or control. Essential to arrangements between the seniors and the common stock is the premise that the latter will attempt to derive for itself (in part from the use of the seniors' contributions) the residual share of the enterprise's value, generally an indeterminately larger share per unit invested than goes to the seniors. Those arrangements rationally contemplate that the common stock will operate the enterprise so as to maximize (or at least to increase), not merely to preserve, the value of its assets. Hence, in contrast to the seniors' limited interest, which directs channeling the use of their contributions in the direction of *preserving* more than maximizing the value of the assets, the common stock's interest is in conducting operations and taking risks so as to maximize the value of the assets and correspondingly their interests. That posture suggests that the commons should deal with the collective assets in their discre-

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<sup>122</sup> The literature on the subject is extensive. Compare William W. Bratton, Jr., *Corporate Debt Relationships: Legal Theory in a Time of Restructuring*, 1989 DUKE L.J. 92 [hereinafter Bratton, *Corporate Debt Relationships*], and William W. Bratton, Jr., *The Economics and Jurisprudence of Convertible Bonds*, 1984 WIS. L. REV. 667 [hereinafter Bratton, *Convertible Bonds*], and William W. Bratton, Jr., *The Interpretation of Contracts Governing Debt Relationships*, 5 CARDOZO L. REV. 371 (1984) [hereinafter Bratton, *Interpretation of Contracts*], with Albert H. Barkey, *The Financial Articulation of a Fiduciary Duty to Bondholders with Fiduciary Duties to Stockholders of the Corporation*, 20 CREIGHTON L. REV. 47 (1986), and Morey W. McDaniel, *Bondholders and Corporate Governance*, 41 BUS. LAW. 413 (1986), and Morey W. McDaniel, *Bondholders and Stockholders*, 13 J. CORP. L. 205 (1988), and Lawrence E. Mitchell, *The Fairness Rights of Corporate Bondholders*, 65 N.Y.U. L. REV. 1165 (1990). See also David M.W. Harvey, *Bondholders' Rights and the Case for a Fiduciary Duty*, 65 ST. JOHN'S L. REV. 1023 (1991); Thomas R. Hurst & Larry J. McGuinness, *The Corporation, the Bondholder and Fiduciary Duties*, 10 J.L. & COM. 187 (1991).

tion without the constraint of self-denying fiduciary restrictions, or indeed of seniors' consent as to how the assets may be used or distributed—except when those matters are addressed explicitly or implicitly in the “contract.”<sup>123</sup>

Not only are traditional fiduciary restrictions thus incompatible with the function of the arrangements between senior investors and common stock, but they are not necessary to effect the protection against opportunism that the seniors require. Senior security holders' interest in current, as well as ultimate, returns is limited. And the priority of seniors' returns focuses their interest on the investment risks that commons take and on common's distribution of assets to itself. That focus is not on *every* such risk or distribution, but principally on risks or distributions that endanger fulfillment of seniors' limited claims. In short, rationally they have only modest concern with deeply and pervasively restraining commons' discretion in such matters. On the other hand, common stock's interest in maximizing residual returns makes it rational to resist fiduciary restrictions (loose or strict) on its behavior. In that context, basing the limits on common's discretion to self-aggrandize on the specifications in the arrangements between the parties is feasible for seniors and more acceptable to commons than imposing fiduciary obligations as the limiting mechanism.<sup>124</sup> That process enables the parties to strike a balance that is not as protective for seniors as would be achieved by fiduciary strictures, but

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<sup>123</sup> The extent to which it is preferable for those constraints to be addressed explicitly (*ex ante*) rather than implicitly (*ex post*) is debatable. See Wayne Easman & P.V. Viswanath, *Implicit Contracts, Economic Efficiency, and Bondholder-Stockholder Conflict* (Nov. 1995) (unpublished manuscript, on file with the *Boston College Law Review*).

The risks that management is expected to take in operating the firm are, at least in theory, those preferred by common stockholders, not those preferred by management; except as embedded in the terms of its compensation, management has no direct interest in the returns from those risks. On the other hand, the risks that common stockholders are expected to take vis-a-vis seniors are those preferred by them, not those preferred by senior investors. Because the two groups are to share in the returns from those risks, the kind of risks and the mode of sharing must be specified or defined. Those matters are necessarily left for contract. Adding traditional fiduciary restrictions on the common stockholders vis-a-vis seniors would be at odds with the function of their arrangements. See generally Hurst & McGuinness, *supra* note 122.

Moreover, the structural conflict between management and common stockholders over the conduct of corporate affairs (e.g., management's rational preference for less risk than stockholders would rationally prefer) is peripheral to the relationship rather than, as with senior security holders, at the core of it. The effort to align management's behavior with stockholder interests that is the function of fiduciary restraints (i.e., the exclusive benefit principle) cannot be effected for a relationship in which conflict is at the core.

<sup>124</sup> Open-ended fiduciary restrictions may (or may not) hamper management or controllers in pursuit of value maximization for the common stockholders. That is a risk the latter must bear in order to protect themselves against management's otherwise uncabined temptation to slack or to divert assets. Such restrictions on commons vis-a-vis seniors are less necessary for the

is in theory at least flexible enough to enable seniors to preclude diversion of assets that threaten their returns.<sup>125</sup> While the seniors lack the cognition and volition in these arrangements that classic contract would require, the relationship between the parties is closer to that of conventionally contracting parties than to fiduciaries and beneficiaries. And if the judicial focus on the problem is adjusted to reflect the circumstances of the arrangements and the protective purpose of the mechanism, seniors can indeed be adequately protected.

Other considerations also argue against fiduciary restrictions on common stock to protect seniors. The notion of "impropriety" in diverting part of the assets or value of the firm to common stock at the expense of seniors requires a definition of the "proper share" of each in the assets or values. The definition is required in part to determine what constitutes misbehavior, and in part to prescribe the remedy therefor. As we have seen, in the case of restrictions on management to protect common stockholders, there is no need to define the "proper share" because management is not entitled (at least structurally) to *any* share. The traditional fiduciary restraint fits with management's lack of entitlement to share by providing that it may not divert to itself *any* interest in the assets or value of the enterprise. But if sharing *is* the entitlement, as in the case of common stockholders vis-a-vis seniors, the fiduciary construct governing managers unravels because it offers no guide to determining "proper shares." Nor is the equality principle that offers protection to public common stockholders against controlling common stockholders available to seniors. The seniors' claim is to unequal sharing, not to equality. Hence, any version of the fiduciary notion leaves one at large on the question of defining and appropriately allocating the shares and the risks entailed in creating enterprise value.<sup>126</sup>

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protection of seniors' limited and prior claims than they are for the protection of commons' interests vis-a-vis management or controllers.

<sup>125</sup> State-imposed restraints on parties to a contractual non-fiduciary relationship derive from the need to set limits on the extent to which the parties in their articulated statements have authorized each to serve himself at the expense of the other. This need arises more because of uncertainties as to what the parties have thus authorized than from the intrinsic inability of the beneficiary to specify restrictions, which is at the base of state-imposed fiduciary obligations. To be sure, some common stockholders' opportunism cannot be anticipated by seniors; but the latter's inability so to anticipate is much less than the public common stockholders' inability in seeking to anticipate managers' or controllers' misbehavior. The only effective solution for the common stockholders' disability is the fiduciary obligation.

<sup>126</sup> Cf. *Robinson v. T.I.M.E.-DC Inc.*, 566 F. Supp. 1077, 1084-85 (N.D. Tex. 1983). The opposition, if not outright conflict, of interests between borrowers and lenders is endemic and explicit, in contrast to the essentially collateral conflicts between agents and principals or among partners. To abstract from that reality and characterize all of the relationships as entailing the same agency costs or fiduciary relationships misses crucial differences.

Seniors might well prefer the protection of traditional fiduciary restraints and the exclusive benefit principle for themselves. But arrangements rooted in the endemic conflict between seniors and juniors over risk taking or maximizing and sharing values argue against resort to such fiduciary restraints. That argument, coupled with the modestly better case for "contract" as a feasible mode of protecting seniors' interests than for protecting stockholders against management or controllers, justifies (if it does not require) avoiding fiduciary restrictions and remitting the parties to explicit contractual solutions.

Maximizing enterprise value may better serve society than maximizing returns to shareholders in circumstances in which decisions to effect the latter necessarily preclude the former. But if the former is the aspiration, traditional fiduciary obligations on the commons, based on the exclusive benefit principle, do not furnish the apparatus for achieving it. To be sure, insofar as corporate fiduciary loyalty restrictions have eroded to require only that transactions be "fair," imposing such diluted restrictions on commons vis-a-vis seniors may not entail an unduly costly imposition on either party or on society. But to the extent that the corporate law fiduciary conception of "fairness" restricts common stock more narrowly than would the good faith or other requirements of contract law, a higher cost than necessary may be imposed by invoking even that species of fiduciary doctrine. Possibly this explains the general, if less than unanimous, judicial disinclination to impute fiduciary obligations to seniors to common stock.

In any event, if the concept of "fairness" is to govern, it must be administered, at least in the first instance, by management. Difficult if not impossible obstacles confront management in the performance of that task.

## 2. Obligations of Management to Seniors

If there is little basis for imposing on common stockholders fiduciary loyalty obligations to seniors in dealing with the enterprise's distribution or investment policy or capital structure, there is little more basis for imposing such obligations on management. If the matter is viewed structurally, and management is seen as the agent (albeit indirect) of the common stockholders vis-a-vis seniors, management should not owe to senior security holders fiduciary obligations that preclude it from favoring common stockholders any more than does its principal. Similarly, if management is seen as the agent of "the corporation," that status imposes restraints on management's self-aggrandizing or careless behavior. But the case remains to be made as to why in managing

corporate affairs managers incur fiduciary obligations to the seniors, or indeed any different obligations than the common stock does in choosing management or otherwise directing corporate affairs.

The conflict of interest between debt and equity over investment or distribution policy or capital structure implicates the economic question of whether the goal of the corporate decision-maker should be to maximize stockholders' value rather than enterprise (and possibly creditors') value if its decision affects those values differently. Traditional fiduciary stricture suggests that the proper decision for management to take is to favor commons' interest, at least until the enterprise is insolvent<sup>127</sup> or reaches "the vicinity of insolvency."<sup>128</sup> At that time, or possibly earlier, it may be necessary and appropriate for the corporate decision-making body (the board and management) to reconcile the interests of the competing claims of stockholders and creditors (and other stakeholders) in maximizing the enterprise's value. If so, that body

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<sup>127</sup> If current federal bankruptcy reorganization law leaves the debtor in possession, in contrast to displacing the debtor with a trustee or creditor representatives as did prior bankruptcy reorganization law, the obligations of management should remain tied to its principal (i.e., the stockholders whom the law keeps in possession). If fiduciary obligations to creditors are to be imposed upon management, its loyalty obligation to common stock should be severed by empowering creditors and disempowering stockholders effectively to appoint management, or by having the court appoint a trustee (as under pre-1978 bankruptcy reorganization law), thus changing the source of managerial authority—and also presumably the managers. Thus to replace management of the insolvent debtor does not deny the entitlement of the debtors' common stock to bargain with creditors through representatives they select. It does, however, align the persons who are managing the debtor with those whose claims on the debtors' assets have matured, and *pro tanto* dominate the common stockholders' claims. *But cf.* *Commodity Futures Trading Comm'n v. Weintraub*, 471 U.S. 343, 354–56 (1985).

<sup>128</sup> See *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*, No. CIV.A.12150, 1991 WL 277613, at \*34 (Del. Ch. Dec. 30, 1991). In either case, distributive considerations and the conflicting interests of seniors and common stockholders in that matter dominate the agenda. Whether in such circumstances management can intelligibly represent both sets of claimants (or "the corporation") in making investment decisions, let alone distributive decisions, is problematic. Indeed, "in the vicinity of insolvency," if not earlier, management's self-interest might align its policies in directing corporate affairs more closely to the interests of debt holders than those of stockholders. In such cases, there may be more need to press for fulfillment of fiduciary duties to stockholders than to create fiduciary duties to bondholders.

Management's obligations should be determined by reference to whose agent it is (i.e. by which principal appoints it). That this "agency" enables stockholders (having only a "thin" interest in the assets) to continue to cause risks to be taken at the expense of creditors (now having a "thick" interest in the assets) is no less an entitlement of their relationship than when the relationship originated. That the situation may give management the incentive to betray its beneficiaries and favor the creditors is simply an extension of the problem of assuring an agent's fidelity. Arguably directors' fiduciary obligations should not shift from stockholders to creditors until the latter are unequivocally "owners," as presumptively evidenced by the initiation of bankruptcy or insolvency proceedings. See, e.g., *Federal Deposit Ins. Corp. v. Sea Pines Co.*, 692 F.2d 973, 976 (4th Cir. 1982); *Geyer v. Ingersoll Publications Co.*, 621 A.2d 784, 787–90 (Del. Ch. 1992); CHOPER, COFFEE & GILSON, *CASES AND MATERIALS ON CORPORATIONS* 48 (4th ed. 1995).

should by law (1) be so instructed, and furnished with appropriate criteria for decision, and (2) be constituted of appropriately weighted representatives of each class of claimants. The costs of thus requiring a regime of bargaining at the board room table may well be considerably less than the costs of making the same persons arbiters for conflicting interests with accountability to none. So long as the board is constructed only of representatives of common stock, that constituency has a claim on its institutional loyalty as fiduciary that is logically prior to any comparable claim by seniors.

If the fiduciary role is viewed as constraining managerial slack or diversion of assets to itself, as distinguished from managerial favoring of the interests of commons over those of seniors, a somewhat different problem is presented. To the extent that such managerial conduct renders the corporation unable to meet its contractual obligations to seniors (e.g., to pay interest or dividends or principal), seniors are entitled to relief from actual default in meeting those obligations. In that process, they may be entitled to assert that management violated its fiduciary obligations to the common stockholders (who in that context are equivalent to "the corporation") and, because recovery for that violation is an asset of "the corporation" which should cushion, if not be allocated to, the seniors, they should be entitled to pursue it. But seniors have no claim to receive any of those recovered assets until their contractual entitlement matures.<sup>129</sup> The fact that managerial behavior so depletes corporate assets as to cause a decline in the prices of senior securities prior to their maturity gives seniors no more claim to force corporate action against management than they would have against common stockholders for directing comparably effective behavior. To allow seniors to enforce such claims when prices drop, but there has been no violation of the contractual obligations of the cor-

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Until then, if the creditors' contract does not entitle them to displace stockholders in control, it is hard to see why directors should become their fiduciaries, and it is impossible to see how directors can at one time be fiduciaries for both (or all) constituencies, or why they should be. Cf. *Credit Lyonnais*, 1991 WL 277613, at \*34; Ann E. Conway Sülson, *Reexamining the Fiduciary Paradigm at Corporate Insolvency and Dissolution: Defining Directors' Duties to Creditors*, 20 DEL. J. CORP. L. 1 (1995).

<sup>129</sup> Management's self-aggrandizing behavior or carelessness or "excessive" risk taking, against which the seniors' contract fails to protect them, are not thereby excluded from the category of managerial behavior against which seniors are legally entitled to protection. But that entitlement addresses behavior only of the kind that would justify stockholder or corporate recovery against management—in contract or in tort or for violation of fiduciary obligations to them. Seniors' standing to vindicate that entitlement rests on the resulting default in their contractual right to be paid rather than on any direct claim as tort victim or as beneficiary. Compare Saul Levmore, *Monitors and Freeriders in Commercial and Corporate Settings*, 92 YALE L.J. 49, 80–82 (1982), with Mitchell, *supra* note 122, at 1195–1200. If common stockholders decline to pursue their available

poration or of the common stockholders to them, would interfere with common stockholders' control of the enterprise in violation of the essential premises of the arrangements between them<sup>130</sup>—whether the issue arises with respect to investment policy, asset management or corporate structure.

It should also be noted that intractable problems arise if management is regarded as having, from whatever source, fiduciary obligations to both common stockholders and seniors. Although the exclusive benefit principle precludes management from diverting any corporate assets or values from the beneficiary to itself, it implicates a broader premise: management receives its power and concomitant fiduciary obligation of loyalty for the benefit of the common stock. But that premise cannot be invoked in deciding how management can or should meet the competing claims of seniors and juniors if the premise is transmuted into a fiduciary obligation to both of them.<sup>131</sup> The same is true for the principle of equality if the competing claims are to unequal return (in amount and in priority). In the absence of relevant contract terms or other instructions, management is left without boundaries set by the parties or the state, and without the support of any signal from the fiduciary notion. The "fiduciary" in such circumstances sits at large, like a Kadi under a tree.

If in theory the fiduciary concept would offer little or nothing to guide management in allocating risks and shares between seniors and common stockholders, in practice it might well produce injury to both

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remedies against self-serving management, it is hard to see why seniors should be authorized to pursue management except as their contract so authorizes. Possibly common stockholders' failure to act may be a function of a controlling common stockholder paying off management for non-corporate obligations that it owes or otherwise distributing assets to itself as controller. The propriety of its behavior vis-a-vis senior investors turns on the provisions of their contract. *See, e.g., Security Nat'l Bank v. Peters, Writer & Christensen, Inc.*, 569 P.2d 875, 880–82 (Colo. Ct. App. 1977); *Rosan v. Chicago Milwaukee Corp.*, No. CIV.A.10526, 1990 WL 13482, at \*6–7 (Del. Ch. Feb. 6, 1990).

<sup>130</sup> Senior securities that are publicly traded may have a claim to protective rules that limit commons' behavior more rigorously than do rules affecting private lenders. When commons alter the risk or dilute the claims of public seniors they affect current price in the market, not merely the likelihood of non-payment of current or future obligations to a private investor. Public seniors may appropriately seek protection against behavior that produces such effects. If achieving it by contract is less effective than achieving it by imputing a fiduciary obligation to the common, doing the latter is more costly. As we shall see, contract doctrine contains suggestions for more effective protection.

<sup>131</sup> *Cf. Robinson*, 566 F. Supp. at 1084. The notion that no person can serve two masters rests in part on the conflicting claims of the two masters and in part on the temptation to yield to expected favors from one or the other of them. In these respects, management's task is not comparable to that of a trustee whom the settlor created, at least in part, to decide between the interests of life-tenants and remaindermen. *Cf. supra* note 14.

sets of putative beneficiaries. As has been pointed out powerfully in the literature,<sup>132</sup> to give management a role that does not tie it to common stockholders but obligates it to be "fair" to conflicting claimants is to enable it to play its obligations to one group off against those to the others. Thus management becomes free to serve its own interests at the expense of all investors or other stockholders.

### 3. The Peculiar Problem of Preferred Stockholders

Even if creditor senior security holders should thus look to contract rather than fiduciary notions for protection against common stock's direction of corporate affairs, preferred stock ("preferreds") may claim protection under the fiduciary umbrella. Preferred stock investors, like bondholders, have a claim to a prior but limited return, in exchange for which they offer funds to be risked at the discretion of the common stock. And like bondholders, their essential economic interest is in the return of principal and current distributions, rather than (as with common stock) with any increased inchoate value of the assets of the enterprise. But unlike bondholders, preferred stock investors commit funds to the discretion of commons without limit of time. Moreover, they have no unconditional contractual entitlement to receive either dividends or return of principal during the life of the firm, or during its insolvency.

In the case of debt, during the period before payment of principal is due, common stockholders have the power to abuse the senior security holders. But in a continuing enterprise, the need to meet current payments and to repay or refund principal imposes some restraint on the common stockholders' use of that power. That implicit restraint may make judicial vigilance in interpreting the investment contract a less compelling need for bondholders than for preferred stockholders.

That the preferred stock is committed to the enterprise without such payment protection does not overcome the objections to protecting it by imposing fiduciary obligations on common stock or management. If such obligations would restrict common's behavior in transactions which the preferred's contract covers more narrowly than the

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<sup>132</sup> See, e.g., ABA COMMITTEE ON CORPORATE LAWS, *Other Constituencies' Statutes: Potential for Confusion*, 45 BUS. LAW. 2253 (1990); James J. Hanks, *Non-Stockholder Constituency Statutes: An Idea Whose Time Should Never Have Come*, 3 INSIGHTS 20, 24 (1989). But see generally David Millon, *Redefining Corporate Law*, 24 IND. L. REV. 223 (1991); Patrick J. Ryan, *Calculating the "Stakes" for Corporate Shareholders as Part of Business Decision-Making*, 44 RUTGERS L. REV. 555 (1991). See also *supra* note 13.



contract requires, they would, as with bondholders, restrict the discretion of common stockholders incongruously.<sup>133</sup> Those restrictions would be more than is necessary in view of the possibility of contractual protection for the preferred stockholders that can be sufficiently effective if the judiciary adopts an appropriately comprehending stance in interpreting the contract—particularly when the challenged transaction entails involuntary and unnecessary redistribution of values between the commons and preferreds.

To be sure, the judiciary has not adopted such an interpretive stance. For more than half a century the courts have systematically, if not uniformly, upheld the commons' view of the scope of its discretion to act opportunistically toward the preferred stockholders under the preferreds' investment contract or the statutes that the contract is said to incorporate. The courts have left the preferreds without formal contractual protection from a wide variety of opportunistic behavior by commons that redistributes values from preferreds to commons—whether commons' management acts unilaterally or effects preferreds' consent to apparently unlimitedly disadvantageous alterations of the contract.<sup>134</sup> Although the courts may have sensed that they were creating problems by thus letting the genie of common stock's discretion out of the bottle, their efforts to cabin that discretion rarely have gone beyond formal admonitory statements.

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<sup>133</sup> This alters the essential premise of the preferred-commons contractual allocations of risk and return to the residual investor. To the extent that fiduciary restrictions would impose restraints on commons with respect to asset management or risk and return allocation to themselves vis-a-vis the preferreds that are not derivable from the contract, they would alter the premises of the parties' express allocation of risk, return and control to the residual taker. To be sure, some limit on commons' allocation of risks and returns is required. But, as with bonds, that limit is better derived from the structure and terms of the contract between common and preferred than by imputation of a fiduciary relationship. See generally Hurst & McGuinness, *supra* note 122.

There are intimations in the judicial opinions and among commentators that management owes fiduciary duties to preferreds comparable to those it owes to the commons with respect to diverting corporate assets to itself. See *infra* notes 135–36; see also Lawrence E. Mitchell, *The Puzzling Paradox of Preferred Stock (And Why We Should Care About It)*, 51 BUS. LAW. 443 (1996). Ironically, preferreds may appropriately claim more protection against such behavior than is allowed to creditors (who presumably must wait until insolvency to seek to recover a corporate asset) because they do not have the same claim of a definite due date and entitlement to enforce failure to pay interest or principal. Thus, arguably they may invoke a more demanding standard of good faith from common stockholders in such matters than may bondholders. See Robert B. Robbins and Barton Clark, *The Board's Fiduciary Duty to Preferred Stockholders*, 7 INSIGHTS, No. 11, at 18, 21–22 (1993). The matter is complicated for preferreds with sinking fund covenants that are therefore not so indefinitely committed, or possibly for participating preferreds that are entitled to share in current residual distributions.

<sup>134</sup> See E. Merrick Dodd, Jr., *Fair and Equitable Recapitalizations*, 55 HARV. L. REV. 780 (1942); E.R. Latty, *Fairness—The Focal Point in Preferred Stock Arrearage Elimination*, 29 VA. L. REV. 1

Doctrinally, the limits were sometimes defined by contract interpretation (as in the case of dividends for non-cumulative preferred stockholders), but more often by reference to conceptions of constructive fraud, illegality, fairness, bad faith or reckless indifference to the rights of others.<sup>135</sup> Only recently has the discourse of fiduciary duties appeared as the doctrinal predicate for imposing limitations on commons' discretion—but with no more success than the other conclusory formulae in delineating commons' prohibited behavior.<sup>136</sup> Nothing that courts have done during the last six decades alters the import of the description in 1937 of preferred stockholders as being regularly "euchered, cajoled, coerced, elbowed and traded out of their legal rights" by the commons.<sup>137</sup> The judiciary's systematic reluctance to

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(1942); Victor Brudney, *Standards of Fairness and the Limits of Preferred Stock Modifications*, 26 RUTGERS L. REV. 445 (1978); see also, *Rauch v. RCA Corp.*, 861 F.2d 29, 30-31 (2d Cir. 1988); *Kirschner Bros. Oil, Inc. v. Natomas Co.*, 229 Cal. Rptr. 899, 903-09 (Ct. App. 1986); *Rothschild Int'l Corp. v. Liggett Group, Inc.*, 474 A.2d 133, 136-37 (Del. 1984); *H.B. Korenvaes Inv., L.P. v. Marriott Corp.*, 1993 Fed. Sec. L. Rep. (CCH) ¶ 97,728 (Del. Ch. June 9, 1993); *Hesston Corp. v. Kays*, 870 P.2d 17, 37-41 (Kan. 1994); *Bove v. Community Hotel Corp.*, 249 A.2d 89, 93-94 (R.I. 1969).

Courts vest commons' directors with virtually non-reviewable discretion to refrain from paying dividends to preferreds, which operates particularly harshly on non-cumulative preferred. *Compare Sanders v. Cuba R.R.*, 120 A.2d 849, 850-52 (N.J. 1956), with *Gutmann v. Illinois Cent. R.R.*, 189 F.2d 927, 928-31 (2d Cir. 1951).

<sup>135</sup> See, e.g., *Barrett v. Denver Tramway Corp.*, 53 F. Supp. 198, 199 n.2, 201 (D. Del. 1943), *aff'd*, 146 F.2d 701 (3d Cir. 1944); *Porges v. Vadsco Sales Corp.*, 32 A.2d 148, 150 (Del. Ch. 1943); *Bowman v. Armour & Co.*, 160 N.E.2d 753 (Ill. 1959); *Zobel v. American Locomotive Co.*, 44 N.Y.S.2d 33, 37 (Sup. Ct. 1943); Note, *Limitations on Alteration of Shareholders' Rights by Charter Amendment*, 69 HARV. L. REV. 538, 544 (1956). The occasional case that permits preferred standing to bring derivative actions may rest on the premise of fiduciary obligation. See *Lowell Wiper Supply Co. v. The Helen Shop, Inc.*, 235 F. Supp. 640, 643 (S.D.N.Y. 1964); *Lewis v. Great Western Corp.*, No. CIV.A.5397, 1977 WL 2574, at \*2-3 (Del. Ch. Sept. 15, 1977); *David J. Greene & Co. v. Schenley Indus., Inc.*, 281 A.2d 30, 35 (Del. Ch. 1971).

<sup>136</sup> See, e.g., *Robinson*, 566 F. Supp. at 1084; *Kirschner Bros.*, 229 Cal. Rptr. at 902-03 (rejecting fiduciary obligations on facts of case); *Security Nat'l Bank*, 569 P.2d at 881; *H.B. Korenvaes Inv. L.P. v. Marriott Corp.*, 1993 Fed. Sec. L. Rep. (CCH) ¶ 97,728 (Del. Ch. July 1, 1993); *Glinert v. Wickes Co.*, 586 A.2d 1201 (Del. Supr. 1990); *Rosan v. Chicago Milwaukee Corp.*, No. CIV.A.10526, 1990 WL 13482, at \*6 (Del. Ch. Feb. 6, 1990); *Jedwab v. MGM Grand Hotels, Inc.*, 509 A.2d 584, 594-95 (Del. Ch. 1986); *Dalton v. American Inv. Co.*, 490 A.2d 574, 582-85 (Del. Ch.), *aff'd*, 501 A.2d 1238 (Del. 1985); *Hesston Corp.*, 870 P.2d at 43-46. *But cf. In re FLS Holdings, Inc.*, No. CIV.A.12623, 1993 WL 104562, at \*4-5 (Del. Ch. Apr. 2, 1993); *Eisenberg v. Chicago Milwaukee Corp.*, 537 A.2d 1051, 1058-61 (Del. Ch. 1987) (involving disclosure obligations); *Dart v. Kohlberg, Kravis, Roberts & Co.*, No. 7366, 1985 WL 11566, at \*1 (Del. Ch. June 25, 1985). The cases offer little help in defining how, or in what proportions or amounts, the fiduciary obligation would allocate benefits between the commons and the preferreds.

For equally ineffectual (and theoretically problematic) references to fiduciary obligations of preferred to common, see *Baron v. Allied Artists Pictures Corp.*, 337 A.2d 653, 660 (Del. Ch. 1975). *Cf. Burton v. Exxon Corp.*, 583 F. Supp. 405, 419-20 (S.D.N.Y. 1984). *But cf. Orban v. Field*, No. CIV.A.12820, 1993 WL 547187, at \*5-6 (Del. Ch. Dec. 30, 1993).

<sup>137</sup> *In re International Paper & Power Co.*, 2 SEC Reports 1004, 1023-24 (1937). For a

protect preferred stockholders in interpreting their contracts does not mean that the fiduciary mantle is more appropriate or protective or that contract doctrine does not offer more supportive approaches.

The fiduciary notion is apparently invoked on the theory that, since preferred stock is "stock," preferred stockholders, like common stockholders, are "owners" of the enterprise. Therefore, controllers (management or controlling stockholders) owe fiduciary obligations to holders of preferred stock as to holders of common stock. Hence, at least in matters not "covered" by the contract, management (effectively the common stock) should be required to act as fiduciaries on behalf of the preferred stockholders and, *pro tanto*, yield at least some of the common stockholders' economic aspirations to the preferred stockholders.<sup>138</sup> The more formal doctrinal suggestion is that matters not covered by the preferred stock contract be treated as matters with respect to which the preferred stockholders enjoy "rights shared equally with the common."<sup>139</sup> In some way that is not entirely clear, "equality" is thought to entitle the preferred stockholders' interests to the same consideration by the common stockholders' managerial representatives in initiating or performing transactions with redistributive effects as they owe to the common stockholders' interests.<sup>140</sup>

But the essence of the arrangements between preferred and common stock is limiting and prioritizing the income and asset entitlements of the former and allocating the residual interest and control

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description and analysis of the unhappy plight of public investors in preferred stock and the doctrinal tangle in which those rights are ensnared, see Mitchell, *supra* note 133.

<sup>138</sup> Mitchell suggests that fiduciary obligations occasionally are (and should be) invoked to restrain opportunistic behavior that the contract is interpreted to permit, or at least not to prohibit. See Mitchell, *supra* note 133, at 458-62. But even proponents of the notion that preferreds and commons "share" rights, see *Jedwab*, 509 A.2d at 594-95, must acknowledge how ephemeral such a "shared" right—and any resulting putative fiduciary obligation to preferred—may be. See *infra* note 144.

<sup>139</sup> See *Jedwab*, 509 A.2d at 594-95. The venerable adage that "all shares of stock are equal" unless preferences or other attributes are expressed "in clear language," ROBERT S. STEVENS, HANDBOOK ON THE LAW OF PRIVATE CORPORATIONS 469 (1949), rests uneasily beside contradictory and more recent notions that preferred stocks' central attributes are a function of contract, see *St. Louis & Southwestern Ry. v. Loeb*, 318 S.W.2d 246, 252-63 (Mo. 1958) (en banc); *Squires v. Balbach Co.*, 129 N.W.2d 462, 465 (Neb. 1964); see also HENRY WINTHROP BALLANTINE, BALLANTINE ON CORPORATIONS 506-09 (1946), and that the statutory provisions applicable to preferred stock are incorporated in the contract. Cf. *Bove v. Community Hotel Corp.*, 249 A.2d 89, 93-94 (R.I. 1969).

The unlimited duration of the preferred stockholders' capital commitment may account for statutory provisions such as those that mandate their power to inspect books and records or to vote by class in certain circumstances. But such provisions are not a predicate for assimilating preferred stockholders to common stockholders or converting a relationship between them that is functionally one of conflicting interests into a fiduciary relationship.

<sup>140</sup> See *supra* notes 138 and 139.

to the latter. The explicit provisions of the typical preferred stock contract thus allocate returns and voting power so as to bring preferred stockholders much closer to the position of bondholders than of "owners." As we have seen in the case of bondholders, restricting the common stockholders' opportunistic behavior by reference to the restrictions contemplated by the traditional fiduciary notion is at odds with the parties' core arrangements.<sup>141</sup>

The terms of the relationship between the preferreds and commons, other than the terms allocating returns and control, are designed to protect those core provisions for the parties. If there is any matter not covered by the contract (or a provision in the contract seems inconsistent with realization of specified preferences or voting powers), it seems reasonable to treat the problem as a gap or ambiguity in the terms of the contract that serve to protect the parties' core relationship—just as the terms governing protection and privileges of holders of warrants and convertibles are treated by courts faced with such gaps or ambiguities.<sup>142</sup> Contract law, which is concerned in part with restricting the power of one party to engage in opportunistic conduct at the expense of the other, offers the appropriate source for determining the limits of the commons' expropriative conduct.<sup>143</sup>

In that function, contract doctrine may be formally comparable to fiduciary doctrine. But, as we have seen, the two sets of doctrine do not prescribe the same limits, even if fiduciary doctrine is viewed in its current flexible form with respect to restrictions on corporate managers or controllers, and contract doctrine is viewed in its more flexible rather than its classical form. Courts have been grudging, if not hostile,

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<sup>141</sup> See *supra* notes 123-27 and accompanying text. The attempted "completeness" of the express provisions of the seniors' contract in matters of control and sharing, however flawed, differs from the substantial "incompleteness" effected in such matters by the "contract" relationship between management or controllers and public common stockholders that requires fiduciary protection for the latter.

That fiduciary notions are inappropriate to protect seniors against redistribution to controlling common stockholders, or against management acting as agent for common stock, need not make it inappropriate to limit managers' self-serving behavior at the expense of both common and preferred, *cf. supra* note 129, as may occur when management diverts assets to itself, as in management buy-outs of enterprises in which management owns little or no stock. See *Jedwab*, 509 A.2d at 595-95. Compare *Dart*, 1985 WL 21145, at \*4-5, with *Eisenberg*, 537 A.2d at 1051 (in which management's only gain was as holders of common stock).

<sup>142</sup> See Bratton, *Convertible Bonds*, *supra* note 122, at 691-98; Bratton, *Interpretation of Contracts*, *supra* note 122, at 373-83.

<sup>143</sup> Thus, for example, the preferred stock contract is often construed to incorporate statutory provisions that give the commons the option to choose one form of merger or amalgamation rather than another, and thereby to alter or circumvent express distributive entitlements of the preferred provided in the document. Or the contract is construed to permit transactions that effect distributions to the commons and leave the preferreds as claimants in a shell enterprise,

to the contract-based notions of "good faith" or "unconscionability" as doctrinal signals to limit opportunistic behavior by common stockholders in such matters—whether the question is seen as interpreting the contract to permit (or prohibit) the common stockholders' behavior or as setting limits on the discretion to allocate the proceeds of transactions that are found to be permitted. The recent ambiguous allusions to fiduciary flavoring in the process<sup>144</sup> have not brought any more analytic light, or any economic solace, to preferred stockholder victims of common stockholders' opportunism. If that opportunism is to be restricted, then notwithstanding other voices,<sup>145</sup> it is theoretically sounder and well may be more feasible to attempt to do so by reference to nascent contract doctrine.

### B. Contractual Obligations To Senior Security Holders

The limited ability of dispersed seniors to bargain and engage in effective contracting to restrict the discretion necessarily vested in the common (and its management) may not be sufficient to overcome the objections to imposing fiduciary limitations on commons' power to engage in opportunistic behavior toward seniors. But to conclude that common stockholders have neither a fiduciary relationship nor its obligations to public senior investors is not to say that the contractual world in which they relate should not take account of the difference between the actual informed consent of a sole actor and the more or less conscripted consent of public senior investors. The failure of

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or in an enterprise that is highly leveraged with increased debt. There is good reason to believe that circumvention of the distributive entitlements of the preferreds should thus be forbidden as a matter of contract interpretation unless more or less expressly authorized or signaled. The question is also raised whether the proceeds of such redistributive transactions have been appropriately allocated between the common and the preferred whose distributive entitlements have been evaded by the transaction thus permitted. If the "contract" is thus interpreted to leave the common stock with discretion to divide the proceeds, fiduciary obligations are as incongruous as the source of restrictions on common stock's discretion in making the division as they are with respect to dividend payments.

The discretion of the Board, generally elected by the commons, to pay dividends to the preferred is rarely (if ever) restrictable by fiduciary obligations; and even though limits derived from conceptions of good faith or unconscionability are looser, they seem rarely to have been invoked. See *supra* notes 134–35.

<sup>144</sup> See *In re FLS Holdings, Inc.*, 1993 WL 104562, at \*4–5; compare *H.B. Korenvaes*, 1993 Fed. Sec. L. Rep. (CCH) at 97,443. Cf. *Security Nat'l Bank*, 569 P.2d at 880–81. Compare *Zahn v. Transamerica Corp.*, 162 F.2d 36, 42–43 (3d Cir. 1947), with *Speed v. Transamerica Corp.*, 235 F.2d 369, 373–74 (3d Cir. 1956).

<sup>145</sup> A discerning analysis of the incongruity of the preferred stockholders' position that sees a role for the diluted corporate fiduciary doctrine in solving the preferreds' dilemma is offered by Mitchell, who also offers a substantive solution. See Mitchell, *supra* note 133.

public seniors' contracts to forbid kinds of opportunistic behavior by commons that private seniors' contracts prohibit should not be taken as consent to such behavior. Considerations both of equity and efficiency suggest that commons' power to initiate redistributive transactions under the public seniors' investment contracts should be limited, except as the instrument expressly authorizes (or at least its selling literature affirmatively signals) the possibility of such opportunistic behavior. Seniors should not be required to bear the risk of *all* opportunistic behavior by the commons that is not expressly prohibited.

### 1. General Considerations

The public senior security investors have the least role of any participants in negotiating or prescribing the terms of the bargain. They have no power directly—and little power indirectly—to negotiate adequate protection by reference to specific conduct or generalized risks. Unlike the issuer, the underwriter or the indenture trustee, public senior security investors do not participate in the bargaining process; they are faced with a “take it or leave it” offer. Moreover, they are the least likely of any of the participants to know or understand the redistributive conduct or risks against which protective covenants are designed to protect, or the terms of the arrangements addressed to such risks. They rationally do not read the indenture or corporate charter, and rarely do, or are able to, parse the prospectus for the meaning of any protective covenants (or their absence) or the risks of possible opportunistic behavior. Therefore, they are likely to receive protective terms less favorable than would a sole lender or private investor who negotiates with the issuer, seeks relevant information from the issuer, and does not suffer from rational apathy.<sup>146</sup> Notwithstanding argument to the contrary, there is reason to believe that the market in such securities functions considerably less than perfectly to reflect bondholders' consent to the presence or absence of many risks of opportunistic behavior by the common stockholders, and protective covenants to offset them.<sup>147</sup>

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<sup>146</sup> See, e.g., Martin Riger, *The Trust Indenture as Bargained Contract: The Persistence of Myth*, 16 J. CORP. L. 211, 215–19 (1991); Marcel Kahan & Bruce Tuckman, *Private vs. Public Lending: Evidence from Covenants* (Feb. 1995) (unpublished discussion paper no. 151, on file with the *Boston College Law Review*). Functionally and culturally the underwriter is even less suitable to bring the initial consent of dispersed senior investors to the table than is the board of directors to carry the consent of dispersed stockholders either initially or *in medias*. Nor does the indenture trustee's interest coincide adequately with bondholders' interests.

<sup>147</sup> Certainly the bond market offers a very poor substitute for consent to assume such risks, particularly for non-investment grade bonds. See, e.g., Sudip Datta et al., *The Pricing of Initial*

As among the parties, therefore, the public investors are the persons least able to protect themselves against the risks that protective covenants are designed to avert. The issuer is the party which the arrangements leave with the widest discretion to act opportunistically. As between the two, equity (on the assumption of a normative preference for informed free choice by contracting parties) calls for the issuer to bear the burden of negating ambiguities or gaps in the contract that might permit injurious consequences to the investor from the issuer's opportunistic behavior.

Quite apart from considerations of equity, considerations of efficiency argue for the same judicial stance. Uncertainty about the meaning of a security contract raises the cost of capital, both when the security is first issued to an investor, and later in its impact on price in secondary trading. It is in the interests of society for the ambiguities and gaps in the meaning of securities contracts to be minimized. A rule favoring public senior investors by resolving ambiguities or filling gaps to allocate redistributive risks to the issuer will give the only active parties in the process who can reduce the uncertainties (the issuer and the underwriter) the incentive to minimize them. Since they, rather than public investors, control the drafting of the investment contract, any excessive rigor in a process that allocates interpretive risks to them can be avoided in the next generation of contracts—an avoidance process that is not as likely to be available to public investors.<sup>148</sup>

To be sure, putting interpretive risks on the issuer, even though the issuer may reduce many of them by adequate advance disclosure, will inhibit the issuer's behavior in ways that may increase its cost of doing business and discourage it from engaging in riskier behavior that may be socially optimal. But increasing the cost to issuers of access to public lenders does not deprive them of access to private lenders or public subscribers to common equity. The question is whether—or to

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*Public Offers of Corporate Straight Debt*, 52 J. FIN. 379 (1996). Notwithstanding ingenious theoretical models to price protective covenants, the market is less than perfect in translating the covenants into price equivalents. Compare Victor Brudney, *Corporate Bondholders and Debtor Opportunism: In Bad Times and Good*, 105 HARV. L. REV. 821, 1849-52 (1992), and John C. Coffee, Jr. & William A. Klein, *Bondholder Coercion: The Problem of Constrained Choice in Debt Tender Offers and Recapitalizations*, 58 U. CHI. L. REV. 1207, 1217-20 (1991), with Marcel Kahan, *The Qualified Case Against Mandatory Terms in Bonds*, 89 NW. U. L. REV. 565 (1995).

<sup>148</sup>This is not to deny that in a variety of situations modifications are made in public bond issues to offset the effects of judicial interpretations that adversely (sometimes quite surprisingly) affect the public investor. See Marcel Kahan, *Anti-Dilution Provisions in Convertible Securities*, 2 STAN. J.L. BUS. & FIN. 147, 160-61 (1995) (showing amendment in next generation of public senior contracts to cover specified leverage increases or control events); Richard A. Steinwurtzel and Janice L. Gardner, *Super Poison Puts as Protection Against Event Risks*, 3 INSIGHTS, Oct. 1989,

what extent—the increased price that the public senior investor should rationally charge for capital (if he understands the risks of opportunistic conduct that he bears under current rules) will impose a greater cost than the cost resulting from the issuer's inability to maximize in the event that the possibilities for such conduct are narrowed. As an abstract matter, because the issuer knows more and can learn more about those uncertainties less expensively than the public investor, even if by definition many of those uncertainties are unforeseen, the least cost avoider would seem to be the issuer. Moreover, to put the burden on the issuer limits the cost of loss of some value-increasing transactions by *some* issuers. But putting the risk on senior investors implicates increased cost of *all* senior capital, even for issuers who are unlikely to need, or resort to, opportunistic behavior.

Thus to shift the judicial stance does not require the interpretive process to immunize the public senior investor from exposure to all risks created by gaps or ambiguities in the investment contract. But it does bring the public senior investor closer to the protection obtained by the private senior investor, whose knowledgeable and volitional contract with the issuer suggests the optimum allocation of such risks that a free market offers.<sup>149</sup> All other things being equal, there is little reason to leave issuers free to avoid restrictions that would benefit dispersed senior buyers or lenders and that sole senior buyers or lenders would impose. Issuers should not be entitled to take more risks with public senior money than with private senior money unless public investors knowingly acquiesce.

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at 3, 3–12; see also William A. Klein et al., *The Call Provision of Corporate Bonds: A Standard Form in Need of Change*, 18 J. CORP. L. 653, 665–68 (1993) (discussing “make whole” clauses proposed for contracts to overcome decisions on refunding at lower interest rates). *But cf.* F. John Stark, III et al., “Marriott Risk”: A New Model Covenant to Restrict Transfers of Wealth from Bondholders to Stockholders, 1994 COLUM. BUS. L. REV. 503, 577–83 (1996).

Such *ex post* modifications to protect senior public investors against judicially permitted commons’ opportunism may constitute evidence of the public investors’ prior expectations, and *pro tanto* suggest that the prior action by commons lacked good faith.

<sup>149</sup> Sole lenders may impose more restraints on common stock’s efforts to maximize values than do “the capital markets” (i.e. public senior investors), and to that extent may impede appropriate risk taking and corporate wealth maximization. See Jonathan R. Macey & Geoffrey P. Miller, *Corporate Governance and Commercial Banking: A Comparative Examination of Germany, Japan, and the United States*, 48 STAN. L. REV. 73 (1995). On that assumption, which is not entirely consistent with borrowers’ apparent willingness to pay higher interest rates to private lenders, bringing the protective powers of public senior investors closer to those of private senior investors may be counter-productive. But an efficient allocation of risks and returns between senior and junior capital requires knowledgeable, free choice in setting the terms of their relationship. Those conditions are not available without advance signals to public senior investors of possible opportunism against which private senior investors guard. To the extent that the market does not, and can not, adequately digest and reflect such signals, and common stock thereby acquires larger



But it is argued that all other things are not equal. Issuers are said to be better able to renegotiate terms with private senior investors than with public senior investors, and therefore are able to accept restrictive covenants from the former that would be costlier to renegotiate with the latter. Issuers undoubtedly incur transaction costs in modifying contracts with public investors that they would not encounter in dealing with private investors. Moreover, there are holdout risks to issuers seeking to reduce the principal payment obligations of public debt. But apart from the possible disadvantage in seeking to effect reduction of principal amount, (to which private investors are not likely to agree except at other costs to the issuer) there is little reason to believe that the relative favorability of terms renegotiated with public investors over those with private investors will be any less than the relative favorability of the original terms negotiated with each of them. The avoidance of transaction costs from renegotiating with public investors must be offset by the cost to the debtor of the bargaining advantages of private investors that are equally present for renegotiation as they are for original issuance.

Nor can a case be made for public seniors receiving less protection than private seniors because the former can diversify better than the latter, or have more liquid investments. The benefits of diversification of risk of opportunism for senior public investors are not as great as the benefits of diversification of economic risk for public common stock investors.<sup>150</sup> Moreover, at least as against risks of opportunism by the issuer, the advantages of diversification do not offer as much protection for public senior investors as the more modest diversification possibilities combined with the ability to negotiate protective terms offer for private senior investors. And while it may be argued that a premium should be paid by public seniors for the advantage

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discretion to make value-increasing decisions from dispersed public senior investors than it gets from private investors, it does so at the cost of exposing the former to opportunistic behavior that the latter is able to forbid or charge for, and does not compensate therefor. That financing enterprise by resort to public markets may sometimes be more efficient for a society or closer to social optimality than resort solely to private financing does not mean that importing monitoring attributes of the latter would not improve the former. See, e.g., Ronald J. Gilson, *Corporate Governance and Economic Efficiency: When Do Institutions Matter?*, 74 WASH. U. L.Q. 327 (1996); Ronald J. Gilson and Bernard S. Black, *Venture Capital and the Structure of Capital Markets: Banks versus Stock Markets* (1996) (manuscript, on file with *Boston College Law Review*).

<sup>150</sup> Diversification against the risks of opportunistic behavior by buying bonds of other companies is problematic because all common stock of all corporations is likely to act opportunistically. And in any event it is considerably less feasible than is diversification against the risks of the run of the mill economic variables, if only because the latter risks are not within the control of the other party and its lawyers. Moreover, even in terms of economic variables, diversification in bond investments merely spreads the downside risk, but does not offer compensatory upside

they enjoy in the liquidity which private senior investors do not have, the strength of the case must be assessed against the significant liquidity that most private senior investors (e.g., institutions) enjoy for their investments.<sup>151</sup>

Finally, there is no evidence that the public senior investors knowingly acquiesce in the risks that they take—but that private senior investors do not take—and there is reason to believe that public senior investors do not know of their disadvantages as compared with private investors. Some evidence suggesting public acquiescence in the risks that they take might be the relative interest charges of public and private senior investors. But that evidence points against public senior investors' acquiescence in greater risks. Typically, private lenders charge higher interest rates than do public seniors, notwithstanding their insistence on protective covenants.<sup>152</sup> The earning streams of enterprises that finance by resorting to sole lenders may systematically be riskier than those of enterprises resorting to public bond markets. That, as well as issuer dealing preferences and the need to compensate for illiquidity, may account for the systematically higher interest rates for private loans, notwithstanding the significant protective covenants that those loans contain but public bonds do not. On the other hand, the difference in interest rates may be attributable more to the systematic bargaining and information disadvantages of holders of public debt compared to holders of private debt than to liquidity, risk differences, or issuer dealing preferences. In that case, the difference between interest rates in the two markets may reflect an inefficiency that can be lessened by legal rules that enhance the protection offered to public debt. Whether such rules would raise interest rates that the public seniors charge or impose unnecessary costs on borrowers are unexplored empirical questions.<sup>153</sup> But leveling the playing field for

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gain as does diversification of stock investments. Investing in stocks of companies whose bonds they buy (or of other companies) offers investors diversification by taking investment risks they do not want, in part in order to benefit from commons' manipulation at the expense of other creditors.

<sup>151</sup> The disparity in costs of illiquidity for private and public investors in stock is not likely to be as great for investors in debt. See generally Francis A. Longstaff, *How Much Can Marketability Affect Security Values?*, 50 J. FIN. 1767 (1995). The risks are so different, and privately acquired debt is not likely to be as unmarketable as privately acquired stock, particularly in view of the easy availability of shelf-registration of debt.

<sup>152</sup> See, e.g., RICHARD BREALEY & STEWART MEYERS, *PRINCIPLES OF CORPORATE FINANCE* 354-56 (4th ed. 1991); Kahan & Tuckman, *supra* note 146. To the extent that protective covenants have value, they should reduce interest rates if present and increase them if absent, *ceteris paribus*.

<sup>153</sup> See Brudney, *supra* note 147, at 1825-27; cf. Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 STAN. J.L. BUS. & FIN. 133 (1994). There is reason to believe that under the

public investors should, in a rational world, enhance efficiency, and in a less than rational world, enhance equity.

The development of contract doctrines to effect comparable protection for dispersed consumers (who cannot and rationally do not bargain over many terms that protect sellers) is said to impose costs on consumers and society that may more than offset the benefits of the interventions thus effected.<sup>154</sup> But in the case of senior security holders, the consequences are not quite the same as for consumers.<sup>155</sup> Public investors have a measure of revealed preference for price concessions over protective provisions that is not available for dispersed consumers in connection with most other standard form contracts. The protective provisions appearing in contracts between an issuer and a sole lender (or a small group of private purchasers of the entire issue of bonds or preferred stock) offer clues as to the preferences for protection at the cost of price asserted by informed sophisticated investors. They also offer some measure of appropriate adjustment of the total terms and price thought preferable by informed transactors who have freedom to agree to those terms.

Possibly, interpretive standards that bring the posture of dispersed senior investors closer to that of a sole investor will result in net increase in the cost of public senior capital to entrepreneurs. At the

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present interpretive regime common stock's attempts to expropriate wealth from public seniors by opportunistic behavior are not infrequent, particularly when the enterprise's value has contracted. See, e.g., Stark et al., *supra* note 148, at 523-28.

<sup>154</sup> Thus the limits imposed by doctrines such as unconscionability or good faith on consumers' choices might reduce the cost savings from standard form contracts and might—or might not—cause sellers to increase prices. It is also urged that such doctrines deny to some consumers a preference between price concessions and assorted protective provisions or might otherwise impose waste upon the society. See Michael J. Trebilcock, *An Economic Approach to the Doctrine of Unconscionability*, in *STUDIES IN CONTRACT LAW* 381, 414-17 (Barry J. Reiter & John Swan eds., 1980); Michael J. Trebilcock & Donald M. Dewees, *Judicial Control of Standard Form Contracts*, in *THE ECONOMIC APPROACH TO LAW* 93 (P. Burrows and C. Veljanovski, eds., 1981); see also, Richard Craswell, *Passing on the Costs of Legal Rules: Efficiency and Distribution in Buyer-Seller Relationships*, 43 *STAN. L. REV.* 361 (1991). But compare Avery Katz, *Your Terms or Mine? The Duty to Read the Fine Print in Contracts*, 21 *RAND J. OF L. AND ECON.* 518 (1990). Those conclusions are not self-evident in theory, and are subject to resolution of as yet unanswered empirical questions.

<sup>155</sup> Investors in bonds and preferred stocks, particularly institutional investors, may not have the same claims to bargaining inequality and information asymmetry or need for protection as do consumers under standard contracts dealing with insurance or utilities or consumer goods generally. Cf. Eric Posner, *Contract Law and the Welfare State*, 24 *J. OF LEGAL STUDIES* 283 (1995). However, in the amendment or merger process, the paralysis implicit in the need for collective action (even when their choice is not otherwise "coerced") makes their trammelled choices comparable; and in the interpretive process, experience suggests that senior securities holders are sufficiently disadvantaged, both procedurally and substantively, to bring the problem within the reach of considerations underlying doctrines of adhesion, unconscionability and good faith. Cf. Eisenberg, *supra* note 79, at 251-54.

margin some value-increasing projects may be lost.<sup>156</sup> But there is no ready way to calculate the socially optimal equilibrium between the issuer's cost and the senior investors' risk if the latter systematically lack adequate information or bargaining power to exercise the free choice that a sole lender or private investor would exercise.<sup>157</sup> Certainly, under interpretive standards that tend to induce common stockholders to give public seniors more intelligible and freer choice in allowing common stockholders discretion, seniors and society are likely to be better off. Seniors' exposure to the risk of opportunism, in potential readjustments or otherwise, will be more rationally reflected in the cost of senior capital than the otherwise unchecked market is able to effect.

## 2. Standards and Rules for Allocating Risk of Opportunism

To urge such risk allocation is not to require risks of *all* redistributive behavior by common stock that injures public seniors to be borne by the former. Some behavior with redistributive consequences also enhances the enterprise's value in a manner that can fairly be said to reflect the appropriate—and contemplated—allocation of risks and returns between the parties. Private senior investment contracts generally contain tradeoffs for allocation of many such risks. The problem remains of fashioning viable standards and rules for protection of public senior investors against risks that they do not, and structurally cannot, similarly trade off. That such protection may be sought in newly minted contract provisions after adverse judicial decisions does not compensate the prior losers. Nor does a judicial stance that more or less regularly permits opportunistic behavior by commons offer protection to transactors in new bonds against new forms of opportunism.<sup>158</sup>

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<sup>156</sup> Costs may well be imposed upon seniors and society if commons fail to initiate readjustments because they fear that more demanding standards would cause courts to set intolerably low limits on commons' receipt from the readjustment. Possibly those costs would be higher than the costs resulting from the present low level of judicial monitoring of indeterminate standards. *Ex ante* fears about the tolerability of "sole lender" and "fairness" standards would not deter the commons from initiating some, perhaps most, readjustments. Requiring them to act in the shadow of more demanding standards and monitoring, however, might deter some readjustments at the margin.

<sup>157</sup> Measuring the cost of deterrence of possible value-increasing transactions at the margin requires inquiry into how large that margin is, and how many of the enterprises whose readjustment is thus deterred would be worse off without readjustment, or indeed should better be in insolvency reorganization or liquidation than readjusted.

<sup>158</sup> To be sure, there has been a steady erosion of protective covenants in publicly-issued debt securities of so-called investment grade. Possibly that is the consequence of "rational choice" by

Exploring potential standards and rules and specifying remedies for failure to satisfy them require a separate inquiry. Seeds for developing them may be found in contract doctrines like duress or good faith,<sup>159</sup> or unconscionability<sup>160</sup> and the attendant conception of "fairness."<sup>161</sup> As we have seen, those doctrines rest on different premises that produce different results than would fiduciary doctrine. They should offer less protection for seniors against opportunism by com-

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investors. See Eastman & Viswanath, *supra* note 123. But, for a considerable volume of debt securities, private investors still demand protective covenants that public investors seem to be powerless to obtain—possibly because underwriters either cannot, or find it unprofitable to, obtain them. See Stark et al., *supra* note 148, at 549–58.

<sup>159</sup> See *supra* note 101. Invocation of the flexible "good faith" requirement would permit appropriate distinction to be made between, for example, (a) mergers or readjustments that are purely internal redistributions, see *Opelka v. Quincy Mem'l Bridge Co.*, 82 N.E.2d 184, 191 (Ill. App. Ct. 1948); *Craddock-Terry Co. v. Powell*, 25 S.E.2d 363, 376–77 (Va. 1943), in which there is every reason to discourage value transfers among the issuer's security holders, and transactions that are purchases or acquisitions by third parties (in which there may be reason to permit such value transfers), see *Goldman v. Postal-Tele., Inc.*, 52 F. Supp. 763, 767–70 (D. Del. 1943), (b) prosperous and faltering enterprises; (c) institutional senior investors and individual senior investors; or (d) holders of straight debt and holders of convertibles.

<sup>160</sup> The notion of unconscionability suggests procedural, as well as substantive, limits on the amendments effected by parties with such structurally disparate capacities to exercise judgment and make choices. Those considerations preclude conduct or enforcement of provisions which a "dependent" party can fairly be said *not* to have reasonably expected or given free and informed consent to, such as prejudicial amendments to which sole lenders would not be likely to have consented or the absence of protective covenants whose availability public investors reasonably could not know. Applicability of the unconscionability or bad faith notion, or even the concept of adhesion, is not precluded merely because the problem stems from the absence of explicit statement of implicit protective provisions for the investor rather than the obscured presence of exculpatory provisions for the corporation. See Eisenberg, *supra* note 155, at 251–54; Timothy J. Muris, *Opportunistic behavior and the Law of Contracts*, 65 MINN. L. REV. 521 (1981) (discussing limits on contract modification).

<sup>161</sup> Thus, in contrast to the proportionate sharing that fiduciary principle requires of controllers vis-a-vis other common stockholders (e.g., in sharing merger gains), good faith embodies a different concept of fairness of result for public seniors vis-a-vis common stockholders (e.g., in sharing losses in recapitalizations). Bankruptcy imposes its own maturing impact on the measure of seniors' claims and its own concept of "fairness" on the limits of any rebargain of those claims. Short of bankruptcy, the concept of "fairness" of common stockholders initiated rebargains with seniors can be given content by requiring their "get" to equal not less than their "give." The seniors' "give" may appropriately be valued by adaptation of SEC interpretations under the Public Utility Holding Company Act of 1935. See 15 U.S.C. § 79 (1994 & Supp. I 1995); *In re Eastern Gas & Fuel Assoc.*, Public Utility Holding Company Act of 1935 Release No. 35–9633, 30 S.E.C. 834 (Feb. 3, 1950); Note, *A Standard of Fairness for Compensating Preferred Shareholder in Corporate Recapitalization*, 33 U. CHI. L. REV. 97 (1965). Common stockholders' "give" can be valued as an option to buy the enterprise from seniors at their principal claim (using Black-Scholes techniques) with the duration of the option determined by the imminence of the maturing of that claim. The value of the entire enterprise sets limits on the sum of the values of the two "gives."

For different conceptions of "fairness" for preferred stock, see *supra* note 134.

mons than would traditional fiduciary obligations,<sup>162</sup> and probably less than is (and certainly less than should be) offered by current diluted corporate fiduciary obligations. But if properly applied,<sup>163</sup> those doctrines would check the dramatic opportunism that prevailing case law permits.<sup>164</sup> To fashion useful standards or rules from indeterminate notions like good faith or unconscionability is not an impossible task,<sup>165</sup>

<sup>162</sup> For example in sharing, rather than being excluded from, gains. See *supra* text accompanying notes 89–103; see also *supra* notes 117, 142.

<sup>163</sup> To proclaim, as courts often do, that “good faith” cannot be used to *create*, rather than to *protect*, “fruits” of the contract that the plaintiff claims to be denied by the defendant’s opportunistic conduct begs the question. By what criteria should courts determine the “fruits” that the contract provides? A focus on the basic objectives sought by the lenders in the explicit provisions of the contract would suggest more “fruits” to be protected than does a focus on all the opportunistic possibilities that the contract’s terms could be construed to permit or to fail expressly to prohibit. The latter focus invites parsing all those possibilities and finding a failure to protect explicitly against a particular act by the debtor to preclude a court from offering such protection because it would be “creating,” not merely “protecting” fruits. The former focus appropriately would have produced different results than the courts reached in the cases like the refunding cases, e.g., *Morgan Stanley & Co. v. Archer-Daniels-Midland*, 570 F. Supp. 1529, 1542–43 (S.D.N.Y. 1983), and possibly the spin-off cases, e.g., *Marriott* bond cases discussed in Stark et al., *supra* note 148 and Robert R. Parion, *Spin-Offs and Wealth Transfers: The Marriott Case*, 43 J. FIN. ECON. 241 (1997), if not the *Marriott* preferred stock case reported in H.B. Korenvaes Investments, L.P. v. Marriott Corp., Fed. Sec. L. Rep. (CCH) ¶ 97,773 (Del. Ch. July 1, 1993). It appropriately would not have produced different results in leveraged buyouts like *Metropolitan Life Ins. Co. v. R.J.R. Nabisco, Inc.*, 716 F. Supp. 1504, 1526 (S.D.N.Y. 1989), *vacated* by 906 F.2d 884 (2d Cir. 1990) or *Pittelman v. Pearce*, 8 Cal. Rptr. 2d 359, 363–66 (Ct. App. 1992). On the other hand, it would have had impact in cases like *Geren v. Quantum Chem. Corp.*, 832 F. Supp. 728, 731–34 (S.D.N.Y. 1993).

<sup>164</sup> Typical preferred stock cases and debt cases appear to offer even less protection for public seniors (who, by definition, have fully performed their part of the bargain) than do cases involving commercial contracts for individual transactors (who may not have fully performed at the time of the other party’s opportunistic thrust) or dispersed transactors like consumers. Compare the results in cases like *Broad v. Rockwell Int’l Corp.*, 642 F.2d 929 (5th Cir. 1981); *Gardner & Florence Call Cowles Found. v. Empire, Inc.*, 589 F. Supp. 669 (S.D.N.Y. 1984), *vacated on other grounds*, 754 F.2d 478 (2d Cir. 1985); *Simons v. Cogan*, 549 A.2d 300 (Del. 1988) (convertibles); *Kass v. Eastern Air Lines, Inc.*, Nos. CIV.A. 8700, 8701, 8711, 1986 WL 13008 (Del. Ch.), *appeal denied*, 518 A.2d 983 (Del. 1986); *Katz v. Oak Indus., Inc.*, 508 A.2d 873 (Del. Ch. 1986) with the doctrine in cases involving commercial transactions discussed in FARNSWORTH, *supra* note 80, §§ 4.26–.28; E. Allan Farnsworth, *Good Faith in Contract Performance*, in GOOD FAITH AND FAULT IN CONTRACT LAW 153 (Jack Beatson & Daniel Friedmann eds., 1995); Todd D. Rakoff, *The Implied Terms of Contracts: Of “Default Rules” and “Situation-Sense,”* in GOOD FAITH AND FAULT IN CONTRACT LAW, *supra*, at 191; see also, Jeffrey C. Fort, *Understanding Unconscionability: Defining the Principle*, 9 LOY. U. CHI. L.J. 765, 771–75, 798 (1973); Hillman, *Policing Contract Modifications Under the UCC: Good Faith and the Doctrine of Economic Duress*, 64 IOWA L. REV. 849 (1979); Left, *Unconscionability and the Code—The Emperor’s New Clothes*, 115 U. PA. L. REV. 485 (1967).

<sup>165</sup> Thus the teaching of the doctrine of duress should support a conception of good faith that categorically prohibits some forms of strategic behavior by common stockholders. For example, common stockholders’ resort to contrived choices (that could not possibly be offered to a sole investor) that pressure dispersed public senior investors to consent to disadvantageous alterations of their contract by leaving them worse off after the amendment they wish to reject than they were prior to its acceptance. The common stockholders thus deny to public seniors the

even though it entails difficulties that cannot always be met entirely satisfactorily.<sup>166</sup> This does not make the task avoidable; nor are the process and its results likely to be more costly than the present interpretive regime.<sup>167</sup>

### CONCLUSION

Conventional contract doctrine entails a substantially different analytic framework and normative import than does traditional fiduciary doctrine in defining the loyalty obligations of the participants and their

freedom of choice that is implicit in their entitlement—by contract or by statute—to vote on amendments or mergers or recapitalizations (as in *Katz* and *Kass*). For opportunistic possibilities derived merely from the existence of structural constraints on dispersed seniors' freedom to assess and choose proposed amendments or mergers or recapitalizations, see, e.g., *Barrett v. Denver Tramway Corp.*, 53 F. Supp. 198 (D. Del. 1943), *aff'd*, 146 F.2d 701 (3d Cir. 1944), a requirement of complete disclosure upon issuing senior securities and full description of relative consequences upon soliciting consent may be sufficient if coupled with a fairness requirement. Cf. HARPER ET AL., *supra* note 80; Ian Ayers & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87 (1989); Ian Ayers & Robert Gertner, *Strategic Contractual Inefficiency and the Optimal Choice of Legal Rules*, 101 YALE L.J. 729 (1992).

Judicial interpretation to fill gaps or resolve ambiguities in public seniors' contracts might seek light on the meaning of good faith in the solutions for comparable problems that appear in private seniors' contracts. Cf. EASTERBROOK & FISCHEL, *supra* note 66, at 34. The absence of protective provisions in the former's contracts that are present in the latter's is more likely to be a function of structural defects than of conscious choice in the contracting process. Possibly, in deference to the bargaining disadvantages of public senior investors (compared to private seniors), good faith might require the issuer to inform public seniors of protective covenants in private contracts that are "traded off" in the public seniors' contract. In any event, the burden of overcoming the failure of the public senior contract to authorize opportunistic behavior, whether or not prohibited in private senior contracts, might be put upon the debtor—e.g. to show that the common stockholders' alleged opportunism is consistent with the core terms of the arrangement—rather than on the seniors to show that it is inconsistent.

<sup>166</sup> For example, institutional investors who (alone or as a group) buy the bulk of a bond issue directly from the debtor may appropriately be treated as a sole negotiating lender. See, e.g., *Metropolitan*, 716 F. Supp. at 1514. But individuals or institutions who buy bonds on the market or from underwriters are in a significantly different position with respect to the bargain in the bond contract. They require—but generally do not have—the information on the opportunistic possibilities against which the sole lender protects but the bonds they buy may not protect. When they buy from the institutions that bought the issue from the debtor for investment, or in private placements, the bonds may not contain covenants, because they were thought to be investment grade or otherwise. See *id.*; Eastman & Viswanath, *supra* note 123. Public investors should be informed of the trade-offs embodied in those debt contracts—by either the issuer or the institutional reseller. The absence of the requisite communication obscures the differences between the bargaining capacity of a single actor on one side of the contract and a dispersed aggregate on the other—differences that are relevant in parsing the notions of "autonomy" and "choice" in interpreting "unconscionability" or "good faith." See *supra* notes 101, 159.

<sup>167</sup> Such systematic interpretive protection does not erode the market function of boilerplate, as might be true if interpretation focuses on the intent of particular parties to a particular transaction. Cf. *Sharon Steel Corp. v. Chase Manhattan Bank, N.A.*, 691 F.2d 1039, 1048 (2d Cir. 1982).

power to authorize departure from them. The former focuses on a party's entitlement to benefit himself, and the limits of that entitlement. The latter addresses the obligation of the fiduciary to serve the beneficiary, and the resulting disability from benefiting himself except as specified expressly. Courts, aided by commentators, have substantially diluted fiduciary obligations of corporate management and of controlling common stockholders in self-serving behavior vis-a-vis other common stockholders—both the conduct proscribed and the quality of the consent required to waive those proscriptions. Nevertheless, the restraints that corporate fiduciary obligations impose retain enough color of traditional fiduciary loyalty restrictions to distinguish them from those imposed by contract doctrine—except possibly as notions in contract doctrine like the requirements of good faith and unconscionability may expand restrictions on opportunism by contracting parties. The wealth-maximizing normative justifications for thus loosening traditional fiduciary restrictions do not offer a convincing case for overturning their teaching—at least in the absence of empirical evidence that has thus far not been shown; and less utilitarian policy considerations suggest retaining their teaching.

In contrast to the claim for fiduciary relationship and obligations from management and controllers to public common stockholders is the claim for such a relationship and obligations from the common stockholders to senior security holders, like holders of bonds or preferred stock. The conflict of functions and interests between commons and seniors are at the core of the relationship and demand restraints. But considerations of efficiency preclude, and considerations of equity do not require, traditional fiduciary restrictions on the former. The economic and functional relationships of the parties fit more appropriately as a concept of contract, albeit one which finds limits on opportunistic behavior by the common stock in contract-based notions of duress, good faith and unconscionability.

Those limits may appropriately be determined by reference to the levels of volition and cognition on which common stock, acting through its management, would deal with sole lenders or sole holders of preferred stock. Those levels may be approximated by placing on the corporation (i.e. common stock) the burden of establishing—by way of *ex ante* disclosure or otherwise—that its challenged conduct does not erode or detract from the core values provided for the seniors in the investment contract. Moreover, the structural obstacles to bringing information disparities and constraints on free choice that afflict public senior investors close enough to the level of sole lenders' transactions implicate a need for an overriding cap of substantive fairness on such dealings. To attempt thus to infuse into the content of the



contracts to which public seniors ambiguously "consent" some of the protection obtained by private seniors who actually consent is not to invoke fiduciary considerations or to import hypothetical actors' aspirations.

Much current scholarship envisions the corporate framework as involving not only the competing interests of investors<sup>168</sup> but also those of stakeholders other than investors.<sup>169</sup> The latter vision of the corporate framework raises questions about the appropriate procedure for making, as well as the substance of, decisions in response to those competing interests. Those questions implicate issues of policy and doctrine that are deeper and broader than any raised in this article. Resolution of those issues invites a wholly "new paradigm"<sup>170</sup> and considerable structural change in the corporate governance apparatus. Little help in that process is likely to be offered by analysis or delineation of decision-makers' duties in "fiduciary" terms<sup>171</sup> or of the judicial power to mold the "contract" concept or of differences between the functions and consequences of the two constructs.

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<sup>168</sup> Many of the problems addressed in this paper also arise in efforts to determine what restraints, if any, should be imposed upon commons' or management's opportunistic behavior toward investors in other kinds of securities. Differences among the roles or functions of those securities in the capital structure may appropriately invite different doctrinal proscriptions of opportunistic behavior. Thus, protection of holders of convertible securities or options may not implicate fiduciary considerations any more than is appropriate for protecting holders of straight seniors. See, e.g., Bratton, *Convertible Bonds*, *supra* note 122; Bratton, *Corporate Debt Relationships*, *supra* note 122. Fiduciary notions may be even less appropriate to protect holders of complex derivatives against opportunism by corporate decision-makers. But see, e.g., Henry T.C. Hu, *New Financial Products: The Modern Process of Financial Innovation and the Puzzle of Shareholder Welfare*, 69 TEXAS L. REV. 1273 (1991); Henry T.C. Hu, *Risk, Time and Fiduciary Principles in Corporate Investment*, 38 U.C.L.A. L. REV. 277 (1990). Conflicts between holders of different classes of common stock, such as dual class voting stock or tracking stock, may well involve contractual, more than fiduciary, considerations, but leave room for the latter. See, e.g., Jeffrey J. Hass, *Directorial Fiduciary Duties in a Tracking Stock Equity Structure: The Need for a Duty of Fairness*, 94 MICH. L. REV. 2089 (1966); D. Gordon Smith, *Corporate Governance and Managerial Competence: Lessons From K-Mart*, 74 N.C. L. REV. 1037, 1051-54 (1996); cf. *Honigman v. Green Giant Co.*, 309 F.2d 667 (8th Cir. 1962).

<sup>169</sup> See *supra* note 13.

<sup>170</sup> See, e.g., Lynne L. Dallas, *Working Toward a New Paradigm*, in PROGRESSIVE CORPORATE LAW 35 (Lawrence E. Mitchell ed. 1995); Lynne L. Dallas, *The Relational Board: Three Theories of Corporate Board of Directors*, 22 J. OF CORP. L. 1 (1996); see also *supra* note 13.

<sup>171</sup> Except possibly with respect to their fidelity to the principals who select them.